

Introduction

I. Tax rates and tax policy

A. Economic neutrality

Definition—tax law should interfere as little as possible with economic decision making; economically equivalent transactions should be taxed the same

- Work v. leisure, spend v. save, consume v. invest
 - Solve problem with absolute neutrality—tax both or tax neither
 - Horizontal inequity creates market conditions that result in economic neutrality
- #### B. Vertical equality—persons in different circumstances should be treated appropriately differently
- 3 choices to address; different economic situations with the same dollar amount of tax
 - Regression*—tax rates decrease as rates of taxable income increase
 - Proportionality*—so called flat tax
 - Progression*—as income increases, pay higher percentage of tax

C. Congress has always used progression as standard for vertical equality

- *Benefit based taxation*—surrogate for measuring overall benefit of being an American is measured by income; those with more benefit should get taxed at higher rate
- *Impact of system on least able to pay*—regressive system protects those who can't pay by making sure they have enough to survive; flat tax would protect if there was a minimum exempt amount
- *Trying to make up for unfairness in other aspects of taxes*—many other state and local taxes that are not progressive (i.e.—sales tax)
- *Ability pay or equal sacrifice*—ability to pay may be related to income; extra income is less valuable; declining utility of services

II. Scope of the Federal Income Tax

3 criterion for gross income: accessions to wealth, clearly realized, TP has complete dominion

A. Every individual is responsible to pay tax

- §1--Congress is silent about definition of individual
 - Use common sense definition
 - Policies behind rule
 - Congress didn't give express restricted meaning, so construe as broadly as possible
 - Word "of" is important because it connotes ownership under common sense definition
- §6012--Can file on behalf of incapacitated individual
- Congress can define terms to mean anything it wants

B. Spreading the wealth

- Wealthy family members should spread money around to lower income family members to reduce liability
- Limit on that ability—"kiddie tax"
 - Congress suspicious of shifting property to very young children, so takes away benefit of lower rates under §1(g)
 - Applies only to unearned income, children under age 14
 - Results in tax liability that is more than what child would pay and less than what parents would pay if each solely liable for tax
- Even when kids are older, can go too far spreading the wealth
 - Taxed by §1(c)—"of" connotes ownership

-If ownership is defined by receipt of benefits, then kid not owner of unearned income he doesn't get to use

C. Principle of fairness embodied in §1

- Higher rates only apply to income that falls into higher bracket, so can never be left off worse financially by making more money
- Principle is that everyone should have to pay tax, but people with more money should have to pay more to the government

D. §11—Corporations

- Definition in §7701 is an "includes" type—not exhaustive, so doesn't exclude other things and common usage still part of definition
- Municipalities are considered corporations due to negative implication of §115(1)
 - Tax must apply before it is necessary to exclude public utility or exercise of essential governmental function
 - Public utility defined by common usage
 - Essential government function—probably means absolutely necessary according to common usage, but case law says wise money management is an essential governmental function
 - Policy for exemption—intergovernmental tax immunity; don't want tax collector to interfere with local government

E. Jurisdictional bases for federal income tax

Citizenship—US citizens pay tax on their worldwide income

Residence—resident aliens pay tax on their worldwide income

Source—nonresident aliens pay tax if income has its source in the US—effectively connected with US trade or business or investment income with US source

- Fairness of jurisdictional bases—do all categories get benefits from our systems?
 - Residents who are not citizens fully partake in our society
 - Non resident aliens don't get societal benefits but do get economic benefits
 - US citizenship standing alone—toddler born in US who never lives here again—benefit of repatriation and right of international protection, but don't really compare to other categories
 - All other developed nations reject citizenship as an independent basis for imposing tax
- §877 Expatriation to avoid tax: non resident aliens who renounce their citizenship in order avoid taxes are taxed on their world wide income for ten year period
 - If renouncing citizenship lowers tax, then we presume the reason for renouncing was to lower tax unless person can prove otherwise
 - WHY? rich people moving abroad and renouncing citizenship so passive investments would be taxed at lower rate under §871

III. Overview of tax computation

- Base US system is taxable income; after §1 whole code devoted to defining taxable income

Taxable income--§63(a)—gross income – deductions

Gross income--§61(a)

Deduction—role is to reduce the gross income and in turn reduce the total income that taxes are assessed against; provides incentives for TP to engage in certain types of activities

-Taken from gross income

-*Non-itemized deductions*—step from gross income to adjusted gross income

-*Itemized deductions*—alternative to standard deduction

- Congress wants less people to itemize for administrative efficiency, so usually passes new deductions that are non-itemized
- Exclusion*—not included in gross income at any point; statutory exceptions for things that would otherwise be in within concept of gross income
 - Reduces tax base
 - Functionally equivalent to a non-itemized deduction
- Why the difference?
 - Usually exclusions refers to receipts/items of value coming in and deductions refer to expenditure/items of value going out
 - Historically, exclusion never appear on tax form at all, while deductions must be reported
- Credit*—credit is applied against the tax and every dollar of tax credit saves you a dollar
- The value of a deduction is dependant upon your tax rate, but value of a credit is fixed regardless of your income
 - Person in higher tax bracket prefers deduction
 - Person in lower tax bracket prefers credit
 - Any TP in tax bracket less than credit percentage rate is better off with the credit
- By structuring tax based encouragement for charitable giving as a deduction, Congress is favoring elitist causes—rich people prefer deduction and will be induced to give
- Foreign tax credit*—US unilaterally relieves TPs of burdens to multiple countries in absence of a treaty so maximum tax rate from all countries combined is never higher than the highest tax rate of the countries
- Amount realized on sale or disposition*--§1001(b)—money received + FMV of boot
- Realized gain*--§1001(b)—amount realized – adjusted basis
- Recognized gain*--required for taxation; §1001(c)—all gain/loss is immediately recognized unless specific statutory exclusion
- Adjusted basis*—trying to keep track of what you've already paid tax on; basis increase occurs whenever income has been recognized; usually cost per §1012

Income in Kind

- I. Non-cash receipts in general
 - Old Colony Trust Co. v. Commissioner*—ER pays EE \$1M in salary and agrees to pay income tax on that salary; \$700K paid in taxes by ER is additional income and tax should be paid on that service because one step transaction is equivalent to EE receiving money and then paying it to IRS
 - Case is cited for recognition of principle of economic neutrality—economically equivalent transactions should be taxed the same; “discharge by 3rd person of an obligation . . . is equivalent to receipt by the person taxed.”
 - EE makes autonomy argument, but isn't persuasive because IRS obligation is legally enforceable
 - Violates economic neutrality because people start rearranging compensation
 - Violates horizontal equality because most workers can't make this deal with ER
 - If not taxed the same, then rich people could negotiate same deal with ERs, but poor people couldn't
 - Foundational holding—substance must prevail over form; when common usage conflicts with purpose of statute, purpose prevails over common usage (i.e. Congress wouldn't have wanted income to be defined as actual receipt if that violates economic neutrality and horizontal equality)
 - Deduction of state income taxes per §164—state taxes vary widely, so person not paying state income taxes has more paying capacity; crucial for equalizing federal income tax burden among states
 - Arthur Benaglia*—room and board provided by ER is tax free because, even though there was enrichment, advantage was incidental to performance of TP's duties; §119 is codification of this holding
 - Majority's position: essential to the employer; business necessity standard
 - TP on call 24 hours a day, so essential he be on premises
 - TP wouldn't have spent retail price on room and board, but was enriched to some degree
 - No EE choice, so value to EE isn't as great; advantage is de minimus
 - Dissent's position: worth to EE; impose tax on amount enriched rather than retail value; look to expenses avoided by TP
 - Room and board compensation because included in contract
 - Not absolutely essential that TP be there—he was manager of 3 hotels, but lived at 1
 - Dissent's position is probably the proper result
 - Convenience of EE should be relevant to amount taxed rather than whether to tax at all
 - Horizontal equity—TP similarly situated to EE who makes his salary plus what he would have otherwise spent on room and board rather than one who makes just his salary
 - Horizontal equity problem will cause economic neutrality problem—people will choose careers where room and board is not taxed

- Application is very dependent on specific facts and circumstances of ER and EE in question
Reginald Turner—tickets won on radio show are worthy less than retail cost of \$2200, but more than \$520 because TP went on cruise; include \$1400 in gross income
- Court is following *Benaglia* dissent by looking to an expenses avoided standard
 - TP could have refused tickets, then enrichment = \$0
 - If TP took the ticket, but goes on trip every year anyway, then enrichment = FMV
 - TP took the tickets, but never goes on trip, so enrichment = expenses avoided
- If good received are transferable, minimum enrichment is net resale value; enrichment is more if you choose to keep the goods
- If goods are not transferable, use expenses avoided to determine enrichment
Haverly v. United States—can't take charitable deduction at FMV for books received as unsolicited samples that were never included in gross income
- Purpose of charitable contribution deduction is that you shouldn't be charged for enrichment you gave away
- IRS usually ignores free samples because enrichment to TP is de minimus

II. More specific statutes

A. §119

Commissioner v. Kowalski—§119 excludes meals or lodging provided in kind, but doesn't apply here because meal allowance paid in cash with no accounting

- §119 replaces case law, and *Benaglia* doesn't survive
- Even if *Benaglia* did survive, SC says convenience to employer means you can't do your job without it, and business necessity isn't present for cash meal allowance

Sibla v. Commissioner—\$3 per shift contributed by firefighters to make meals on site in city provided kitchen are not taxable under §119; even though meals aren't provided in kind, TP's consumption is constrained

- Dissent finds no constrained consumption—choose on food; only thing controlled was location where eating—just collective decision making
History of §119
- Treasury wrote opinions for interpretation of §119 and defined convenience to ER as "helpful" because convenience applies to both food and lodging, while lodging has extra requirement of business necessity
- Kowalski* rejects IRS definition and says convenience means business necessity
- Congress added §119(b)(3)—sometimes applies to cash, not just in-kind because there is only a formal difference between EE who receive higher salary and buy own food and EE who receives lower salary and food is provided in kind
- Congress chooses substance over form and does away with *Kowalski* formalistic distinction between cash and in kind

B. §107

- Applies to religious personnel and rule is much more relaxed; no explicit test
- Enacted before *Benaglia*—don't take away because political ramifications
- No distinction between in cash and in kind and allows furnishings to be deducted
- Does word "provide" cover buying a home? Probably only applies to this year, not future years

C. Other fringe benefits §132

- Must pay taxes on fringe benefits unless you can point to a specific statutory exclusion
- Reasons for statute
 - Practice of giving goods to employees is long established and never considered taxable income
 - Need to set forth clear boundaries
 - Afraid without regs, tax base would shrink significantly
 - Need nondiscrimination between higher and lower level employees
- Seven categories are excluded: no-additional cost services, qualified employee discounts, working condition fringe, de minimus fringe, qualified tuition reduction, X and Y
- If TP has to include some amount of fringe benefit in income, probably should look to expenses avoided, but Congress says use FMV
- How to determine de minimus? Individualized standard—how much am I enriched?
- Non-discrimination clause for discounts: substantially same terms and group

III. Imputed income

Definition—income that does not involve a receipt; results from the investment of capital or performance of services for one's own personal or family use

- NEVER been taxed
 - Administrative concerns justify omission of some items received in kind
 - Impractical and maybe not desirable to include all good things in life in income
 - Unfair because imposes smaller burden on some TPs than on others in overall similar circumstances

ECONOMIC NEUTRALITY PROBLEMS:

- Creates major incentive for buying a house because IRS treats homeowners different than renters—no deduction for rental costs, but no tax on rental value of owned home
 - If tax home owners on imputed rent: administrability problem because hard to figure out rental value
 - If give deduction for rental value, no administrability problem, but lost revenue; no incentive to buy so people change behavior in line with actual desires; economic neutrality problem because housing in general is a better investment than anything else
- Because §262 makes personal living expense non-deductible and homemaker services are free, many people working in the home don't go to work even though services would be much more valuable in the work place
 - If tax imputed income from homemaker's service, administrability problem
 - If provide deduction for money spent to replace homemaker's service then tax law would be neutral in choice between working in home and out of home
- Trade of services is not imputed income, but gross income—payment for services with services
 - MESSAGE: if you want something done tax free, do it yourself or get someone in household to do it
 - IRS only worries about this when abuse is significant

Compensation for Losses and Return of Capital

I. Damage awards

- When sale proceeds represent recovery of a prior investment, they are not income because to constitute a gain they must exceed prior investment *Edward H. Clark*—payment to TP by attorney was income to TP because source of liability was malpractice by attorney; if 3rd party causes liability, no enrichment when liability paid by 3rd party
- Different that *Old Colony* because source of liability there wasn't 3rd party but TP
- Vertical inequality-TP who doesn't consult professional is liable for entire tax bill
 - If give deduction for mistake in taxes, then inequity is solved
 - If give deduction for all tax payments and credit for all refunds, then just have to have higher percentages
 - Collective consumption expenditures—government pays for things with your money you don't have to pay for; local taxes fit, but harder to see state and federal taxes as consumption
- POINT: 3rd party payment of TP's liability is income under *Old Colony Trust* unless 3rd party caused the liability as in *Clark Raytheon Production Corp. v. Commissioner*—payment received for settlement of suit are income because damages received by Raytheon from RCA were owed to RCA for anti-trust violation; must ask in lieu of what were damages received; called it even, but actually a step two step transaction because Raytheon received damages and paid liability to RCA
- Some of money paid to Raytheon was for good will, but no proof of the cost of good will, so tax the whole amount—no proof because good will was self constructed
- *Commissioner v. Glenshaw Glass*—punitive damages are taxable because they are undeniable accessions of wealth; there is nothing for enriching than a windfall
- Congress addressed situation in §104(a)(2)
 - If settlement is for physical sickness or injury then not taxable
 - If settlement is for compensatory damages, even lost wages or future wages, then not taxable
 - If settlement for punitive damages then taxable
- Rationale of §104
 - Allocation problem: trial judges don't allocate awards and Congress won't make them because of federalism; makes no sense to have federal trial to allocate; Congress could either tax everything or nothing and bad policy to go after hideously maimed tort victims
 - Income bunching: lump sum now increases tax liability—only get one set of lower brackets rather than application to each year's salary
 - No problem with punitive damages, because must be reported separately at trial court

II. Previously Deducted Losses

Net operating loss—excess costs over revenue; negative profit

Loss on the sale or disposition of property—negative gain; §1001

Casualty loss—sudden damage or destruction of property due to natural forces; negative windfall; see §165(c)(3)

Burnet v. Sanford & Brooks Co.—S&B sued government for losses in performing contract and awarded \$175K; S&B wants transactional accounting because no income to offset when original deductions for loss taken and change in percentages of taxation in year of payment; held that full amount is taxable because enrichment calculated on a year by year basis rather than on a transaction basis per §441(a)

- May be unfair to tax receipt side of a no-profit transaction, but still constitutional because 16th A doesn't call for fairness and annual accounting was in contemplation of the drafters
- Congress responded with §172(a)—net operating loss carryover or carryback—inclusionary side of tax benefit rule
 - When you are entitled to deductions, but they don't save you any taxes you can take extra deductions some other year when you do have income to offset
 - First carry extra deductions back two years
 - If no income, then carry forward until year with net income
- Usually *Raytheon* is applied to awards of damages, but same result
 - In lieu of what were damages received?
 - Negotiated for higher contract price if had known extent of work to be performed
 - Compensation for services are taxable, so higher contract fee would have been taxable

Dobson v. Commissioner—no income when settlement received due to fraud because TP still suffered a loss; loss for sell of stocks in prior years was not fully compensated for by settlement

- If governed by *Raytheon*
 - In lieu of what were damages received? Partial refund of purchase price paid in 1929 because of fraud
 - Refund = accumulated after tax income
 - NOT taxable if *Raytheon* applied
- Exclusionary side of tax benefit rule—deduction is incorrect in retrospect, but don't need to fix it because the error is harmless and didn't save you any taxes
 - Don't enforce inclusionary side of tax benefit rule if it will do more harm than good
 - If settlement exceeded losses, then that portion of settlement would be taxable as a capital gain
 - Codified in §111—if you recover amount of deduction, but deduction didn't do you any good, then amount recovered is excluded from gross income
- Can't apply §172 to *Dobson*
 - No net operating loss, only negative gain
 - But see §1212(b)—carry forward rule for capital loss

III. Tax Treatment of Health Care Costs

POINT: ER provided health care is entirely tax free

- §106—employer provided health care coverage
 - Enrichment to EE: if ER didn't pay, EE would pay costs directly
 - Congress declines to tax
- §105—treat of proceeds of ER paid policy
 - Included if §106 applies and are paid by ER
 - Gross income does not include money paid for reimbursement of expenses incurred for medical care
 - If premiums finance medical care, then premiums are not taxed are proceeds are not taxed if applied to medical care costs
- §213—Medical care: includes diagnosis and treatment, transportation, long term care services, insurance
- Self insurer only gets to deduct medical costs to the extent that they exceed 7.5% of adjusted gross income

- Itemized deduction
 - Save money only if sum of all itemized deductions exceeds standard deduction
 - WHY? Congress wants to promote social policy of broadly available health care insurance
 - Current debate: limit §106 to decrease inflation of health care costs
 - Get tax free benefit, but tie to reasonable amount so that plans covering second opinions, etc. cost more than benefit to EE
 - Have catastrophic coverage, but not gold-plated coverage
 - Disability insurance coverage
 - \$105 only applies to medical care, so if ER provided proceeds are taxable in full
 - If self insure, premiums are non-deductible but proceeds are excludable
 - Choose ER plan—most people never have to collect
- Ochs v. Commissioner*—although kids were sent to private school because mom was sick and dr. said stress would make her more sick, tuition is not deductible because benefits kids; court implies a strict construction of §213
- §262—no deduction for personal living or family expenses; this expense is room and board for kids and education costs
 - Ways to handle dual purpose expenditures
 - Old Colony Trust*—direct v. indirect
 - Doctor's orders—easy to abuse (dissent)
 - "But for" causation or purpose—family would never sent kids to boarding school if mom not sick because couldn't afford it (dissent)
 - Custom/convention—usually boarding school is personal consumption (majority)
 - Sort out relative benefits or effects—sort out what part of monthly check was related to medical costs
 - Congress recently adopted doctors orders approach when it comes to long term care services per §7701(b)

IV.

Annuity Contracts

Definition—issuer promises to make payments for life of annuitant; designed to protect TP from outliving his/her savings

Joint and survivor annuity—payments continue for as long as either of two survive

Ways to Tax Annuitants

- Return of capital—no tax until total payments received equal what was paid in
 - 3% rule—payments treated as taxable income to the extent of 3% of annuitant's investment in contract and rest taxed on return of capital basis
- Egvedt v. United States*—3% rule is not unconstitutional even though [] could not live long enough to get investment returned under the rule
- Exclusion ratio rule*—§72 allocates annuity payments between income and return of capital
- Mortality gains and losses*—adds to §72; drop in tax income if outlive expectancy and deduction for estate if person dies early
- Depreciation deduction for other wasting investments §167 is equivalent to exclusion ratio device in §72
- Employee annuities*—not gross income if made pursuant to qualified retirement plan based on §403(a)(1) or (b)(1)
- Ways to allocate receipts between income and return of capital—all tax exactly on amount of enrichment, so choice is arbitrary
 - Return of capital first rule*—no tax until TP gets all his money back
 - Return of capital last*—tax income first, then give TP investment back
 - Pro-rata return of capital*—% of each payment is income
 - Back loan return of capital*—in substance TP is making a loan to insurance company and company pays back TP over length of contract; mortgage amortization
 - Front loan return of capital*—reverse of mortgage amortization
 - Issue is really timing of taxation rather than amount to be taxed; see §72
 - \$72(b)(1): exclusion ratio = investment in contract/expected return = not gross income
 - \$72(c)(1): investment in contract = aggregate premiums or other consideration – amount received before start date
 - \$72(c)(3): expected return = life expectancy x payout per year
 - Changes to §72 in 1986
 - If TP lives longer than expected, every penny received thereafter is taxable as enrichment
 - If TP dies too soon, estate can deduct un-recovered investment in contract
 - WHY? exclusion ration used to apply to every payment regardless of life
 - New rule better reflects enrichment
 - TP buying in installments ends up paying much less for benefit than TP paying lump sum
 - Exclusion ration will be lower for TP buying in installments
 - TP buying in installments will pay more tax
 - TP buying in installments gets tax deferral in interest
 - ECONOMIC NEUTRALITY PROBLEM: Both TPs are getting same thing, but different tax consequences, so influences behavior
 - Pre-start date withdrawals from an annuity—§72(e)
 - Originally, taxed as return of capital first
 - Now, considered tax abuse or attempt to get unwarranted tax deferral so uses return of capital last

V.

Life Insurance

- Two types: pure life insurance and insurance with savings component
- Whole life*—buying year by year term insurance and part of premium put aside and invested
- Correct tax treatment of pure insurance: should be governed by what it is intended to replace
 - Premiums come out of after tax income
 - Proceeds are replacement for wages so should be taxable (*Raytheon* and *Old Colony*); ----What about return of premiums? Maybe cost of producing the income
 - Premiums for loss of homemaker's life should be non-taxable because imputed income is not taxed
 - If beneficiary is adult children, then really making a bequest which are tax free under §102(a) and §1014
 - Correct treatment for whole life insurance: if TP put money in savings account and bought term, each would be taxed year by year; and gain would be taxed upon death
 - Congress' treat of insurance:
 - Proceeds due to death from pure life or whole life are always tax free per §101(a)(1)
 - Proceeds from maturity of whole life contract are governed by §72(e) if lump sum and §72 if annuity

- Sale of life insurance contract
 - Owner taxed on enrichment—compute gain under §1001(a)
 - Buyer taxed only cost only on amount above cost of contract; cost of sale also includes premiums you had to pay after purchase—see §101(a)(2)
 - If sale due to terminal illness and need money for hospice care or sell on death bed, apply §101(g)(1)—treat as if payment of death under §101(a)(1)
- §101(c) applies when insured dies and company pays lump sum or settlement option; no tax deferral on interest component if left on deposit with company
- §101(d) applies when beneficiary chooses ten year certain annuity, but interest is also paid on principle; exclusion ratio approach to annuities—pro-rated amount is tax-free (death benefit)

Capital Appreciation

I. Eisener v. Macomber

A. Four options for disposition of corporate profits

1. Retain and invest in business
2. Retain, invest in business and issue stock dividend
3. Issue optional stock of cash dividend
4. Distribute to shareholders as cash dividend

B. Majority opinion

- Shareholder didn't derive a gain from corporation on receipt of a stock dividend because it is a purely formal transaction
- Every stockholder got a 50% increase, so TP has no substantive change in ownership—after transaction she has more pieces of paper but same proportional amount of stock

C. Dissent opinion

- Congress drew the taxation line after #1 (above), which is okay because #2 and #3 are functionally equivalent and shouldn't be separated

D. Majority's response to dissent

- Analogy between #1 and #2 is stronger than that between #2 and #3
- Only difference between #1 and #2—mail a certificate in #2

E. Dissent's response to majority's response

- When analogy between all four is so strong, line drawing should be left to Congress
- Power to tax effectively includes a power to define income within reasonable limits

F. Statutory treatment §305

- No tax if only a formal change
- Tax if change in substance (alteration of proportionate ownership of stockholders)
- §307—allocate adjusted basis by relative FMV so that sale of any part of fungible property generates the same loss

II. Helvering v. Bruun

A. Holding

- Gain was realized on improvements when tenant defaulted on 99 year lease because transaction was over, tenant was off the land, and landlord gained value of improvements put on land by tenant
 - Court is reinterpreting *Eisener v. Macomber*
 - Income to TP was a windfall—lease for 99 years, but improvement only had life of 50 years
- Taxable income*—gross income – deductions (costs of producing income)
- Depreciation deduction*—show fact that some property deteriorates and is less useful over time; adjusted basis in property/period of use

B. Congressional response §109 and §1019

- Realization has to occur to have income at all, §109 grants statutory exclusion for realized gain
- Exception: tentative improvements in the nature of rent are not excluded

- Bargained for obligation to build/improve = rent in kind
- If land is useless without improvement, then substance over form
- Exclusion in form, but only a timing rule in substance
- §1019—if TP doesn't pay tax because Congress granted that privilege, then you don't get a basis increase—no future depreciation and no basis off-set on sale
- C. Exchange of land for land §1031
- Under *Eisener*, there is a gain in an exchange
- Similar to selling the land and using money to buy what you want
- §1031—no recognition if exchange of property, property given up is used to generate income and exchanged solely for property of a like kind, but tax up to the amount of boot received in swap
 - Land for land is "like kind" if both parcels in US
 - WHY? property is set of legal obligations rather than piece of ground
 - See IRS regs 1-1031
- Basis rule--§1031(d)—basis of property given up – (money received + gain/loss); boot gets assigned firm and always gets FMV basis, then remainder goes to like kind property
- §1031 (c)—realized loss is not recognized when swap occurs, but is preserved for recognition upon sale of property so TP doesn't have all the control on timing; you can always deduct loss by selling for cash
- SO, in like kind property swaps, we tax all gain when boot received, but can't deduct loss regardless of whether boot is received
- Even exchange hypothesis*—assume FMV of properties in exchange are equivalent because wouldn't engage in exchange unless property you receive is as valuable as the property you gave up
- Policy reasons for Congress is granting tax deferral in §1031
 - Encourage investments in land over investments in corporations through exceptions in §1031(a)(2)
 - No tax deferral on inventory exchange due to liquidity concerns—if impose tax, TP might have to sell property to pay tax—incomplete justification
 - Administrative convenience—hard to determine gain or loss if you don't know value of property with certainty; defer tax until sale then know how much property is worth
 - Taxpayer compliance—don't want people to sell traded property to raise money for taxes
 - Horizontal equity—not enough difference between holding onto something and swapping it for something similar to warrant taxation
 - Economic neutrality—probably real reason—concerned with capital lock-in
- Manufacturing exchanges to qualify for tax deferral: limited by 180 timing requirement in §1031(a)(3)
- D. Municipality Converts Property §1033
- Two different non-recognition rules
 - If converted into property, no gain recognized
 - If converted into cash, meet timing requirement, property is like kind, then non-recognition only for amount realized in excess of replacement property
- Congress not looking for "like kind" replacement, but for functional equivalent
- Different from §1033 because no difficult in valuation—property is converted into cash by local court
- E. Family home §121
- Exclusion for gain realized from disposition of principle residence if lived there 2 or more years during 5 year period

- Basis in new house = normal rule of cost because no specific rule listed
- Tax forgiveness
- F. Cottage Savings Assn. v. Commissioner
Holding—application of *Bruun* principle to loss transaction; looking for a material difference (minimal standard) in property being swapped to trigger realization; no realization for identical property
 - Court seeming to move away from *Eisener* holding that realization is a matter of constitutional law
- F. Sale to Family Members §267
 - Disallows deduction for loss if sale to a family member
 - Loss is gone forever because family member gets cost basis upon resale
 - But, if family member resells property for a gain, gain is recognized only to the extent it exceeds TP's loss
 - Rule applies to functionally equivalent transfers because “directly or indirectly” language—stock publicly traded and brokers buy and sell on behalf of family members
- G. Wash rule §1091
 - Sell stock and then buy identical shares within certain time period, no deduction allowed under §165
 - Merely deferral of loss because basis of shares purchased is cost basis + disallowed loss

Receipts Subject to Offsetting Liabilities

- I. Income Tax Treatment of Loans
 - TP borrowing funds has no income, but not allowed deduction for repayment of the loan because getting cash from a loan comes with an equal and offsetting legal obligation to pay it back
 - Merely a change in form of wealth from good credit to cash in hand w/ repayment obligation
 - Money is going out, for each dollar repaid reduces liability by a dollar
 - Vertical equity concern: don't want to put in different tax bracket when no enrichment because you have to pay loan back
 - United States v. Kirby Lumber*—corporation had income when bought back bonds at lower rate, resulting in a gain of \$138K; income from the discharge of indebtedness
 - Enrichment rationale: some assets have been freed from claims of all creditors; looking to total financial situation
 - Recapture rationale: to the extent you don't pay back the loan, we've got to catch up with you; no insolvency exception because still a windfall
 - Congressional response*--§112; pure enrichment when indebtedness is discharged
 - Insolvency exception*—issuer is insolvent before and after transaction, then no income from the discharge of indebtedness
 - Rule of Lakeland Grocery*—if assets > liabilities after buying back bonds then enrichment has occurred
 - Congressional response*--§108(a)(1) and (b)—
 - Statutory exclusion for debt reduction during bankruptcy and insolvency
 - BIG CATCH: under (b) net operating losses are reduced by amount that is tax free, so less to carry over/carry back; same applies to capital losses; basis is reduced so future depreciation is lost

-Tax deferral: not taxing you when creditors reduce the gain, but catch up with you later when you have income but no net operating loss, capital loss or depreciation deductions to protect that income

David Zarin—no income to TP when suit for payment of gambling debt settled for amount less than amount of debt; court allows TP to deduct gambling losses from gambling income in a different year—goes against *Sanford & Brooks*

- Wrong result—huge windfall to TP and *Glenshaw Glass* says income includes windfalls
- Right result—only if there had been a good faith dispute as to value received; lemon cases—car turns out to be a lemon then negotiate a reduction in debt which is treated as a reduction of purchase price rather than discharge of indebtedness
- Congressional response--§165—losses from wagering transactions only allowed to the extent of gains from such transactions

II. Claim of Right

Doctrine—conditional repayment obligation is not a loan for tax purposes—cash flow treatment

-Repayment only conditional, so no equal and offsetting liability

-If not, TP encouraged to assert potential repayment obligations to achieve tax deferral

North American Oil Consolidation v. Burnet—obligation to repay is conditional (based on outcome of appeal) so can't invoke loan treatment to get tax deferral now and then pay tax when indebtedness is discharged; taxable year is year of receipt because claim of right to funds

- §446—use same accounting method for business purposes and tax purposes
 - Cash receipts and disbursements*—year for accounting is year of actual/constructive receipt
 - Accrual*—year for accounting is year when all events occur that fix right to income and amount can be reasonably estimated
 - Court uses cash flow tax treatment: receipt occurred in 1917; if TP loses on appeal will have to pay back in 1922 and will get a deduction for any amount repaid = net out to right amount
- United States v. Lewis*—when TP paid tax on bonus, then half of bonus taken back by employer (sues and wins), TP is entitled to a deduction for loss rather than re-computation of taxes
- Problem: TP not made whole because change in rates in intervening years
 - Congressional response: §1341(a)—if deduction is more than \$3K, then tax imposed for year of repayment can be changed or TP can take deduction

III. Embezzled Funds

James v. United States—embezzled funds not treated as loan for tax purposes; when you still the money, we tax you and then you get a deduction when you pay it back

- Same as claim of right doctrine, BUT—in this situation there is at all times a condition offsetting the legal obligation to pay, but obligation can't be enforced because lender doesn't know about it and embezzler is generally enriched

McKinney v. United States—embezzler claimed funds, then paid back and wants deduction; no deduction under §1341 because no legal right to funds; no deduction under §172 because not trade or business

IV. Non-recourse borrowing

Definition—borrower is not personally liable; lender can foreclose on security interest only

Crane v. Commissioner—even if non-recourse loan, amount realized is not just the equity paid; it includes the indebtedness

Commissioner v. Tufts—wrong result; treats whole transaction as a property transaction where you have disposed of property for full principle balance

- Right result: unscramble the transaction

- Property transaction and mortgage transaction
- Land is being sold for FMV and result is a capital loss
- At the same time, income accrues from discharge of indebtedness and results in an ordinary gain
- IRS settles for getting net amount of income right even if character is wrong
- Congressional response: §7701(g)—for all income tax purposes, determine amount of gain/loss with respect to any property; FMV = not less than any amount of non-recourse indebtedness attributable to the property—NO UNSCRAMBLING

Gifts and Kindred Items

I. 2 Rationales for Gifts

Material Consumption—allow deduction for donor because cash is enrichment to donee because it is available to fund donee's consumption, but cash is no longer available to fund donor's consumption

Intangible Consumption—donor can't spend cash on consumption, but before donor made the gift he could have spent it any way he chose; get intangible benefits from making a gift so fact that person makes a gift means he is getting a greater benefit from making a gift than from consumption so no deduction needed

II. Congressional Treatment of Gifts

- §102(a)—express statutory exclusion for the donee
- §170(a)—deduction allowed for charitable contribution; negative implication is that gift to person is not deductible
- Congress taxes the donor and not the donee, so chooses neither rationale
- WHY? administrability concerns
 - Material consumption problem: progressive rate system means donees are in lower tax bracket because seems unfair

Irwin v. Gavit—gift received by TP wasn't property, but income itself under a testamentary trust/will; still must pay tax on the income

- Congressional response: codified holding in §102(b)(1)
- Combined message of §102(a) and (b): only exclusion for value of gift received when received; all income from income producing property will be taxed regardless of whether income or property is actual gift
- Remaindermen still get benefit of gift under §102(a)
- No amortization for gift of income: §273—amounts paid as income for holder or life or terminable interest by gift, bequest or inheritance shall not be reduced by any deduction for shrinkage by any name called in respect of decedent in value as a result of lapse in time
- If income beneficiary sales income interest given as a gift
 - Purchaser gets depreciation or amortization allowance but donee is not allowed depreciation or amortization deduction because exclusion of §102(a) is only available to remaindermen
 - §1001(e)(1) and §1014/§1015—gift, bequest, devise or inheritance is disregarded and adjusted basis is zero so donee pays tax on entire sale proceeds
- If income beneficiary and principle beneficiary sell interests together, then parties get split FMV basis

Commissioner v. Early—TP receives gift of stock from client, but at will contest agrees to settlement where TP gives back stock and takes income interest in trust; treat as one transaction for settlement of a disputed ownership claim or one ongoing settlement of right to receive anything

- Basically, applying *Raytheon*: damages were received in lieu of gift so settlement is treated as a gift for tax purposes
- Taft v. Bowers*—gift of property that has appreciated by never been taxed; donee takes basis of donor under §1015(a) and will be taxed on realization event
- Congress has never imposed general rule of realization by gift or bequest, even though right in theory
- §1015 grants tax deferral and income shifting for gifts; BUT—if transferred basis is greater than FMV at the time of the gift, then to determine loss basis will be FMV
- §1014 for bequest, devise or inheritance: tax forgiveness for appreciation during lifetime and complete disallowance of decline in value during donee's lifetime; results in capital lock-in and liquidity problems
- §1022 has general rule of carryover basis at death with a \$1.3M basis and additional \$3M basis for transfers to spouses; after 2009, §1015 is replaced with §1014
- §7701(a)(43)—donee steps into donors shoes for subsequent sale of gifted property; adjusted basis is transferred along with property (carryover basis)
- SO—tax neither donor or donee at time of gift, tax donor earlier through adjusted basis and tax paid investment and tax donee later to extent of appreciation; can't shift deductions by shifting depreciated properties but can transfer enrichment

III. Prizes and Awards

Common law—before §74, if get valuable transfer, it might be seen as a gift and it might not
Pauline Washburn—check from Tums awarded for answering the phone is not taxed because can't be seen as compensation when TP refused to give endorsement and still received money

- Could be seen as a windfall, but decided before *Glenshaw Glass*

Congressional response

-§74: prizes and awards shall be included in gross income unless for scientific, literary or artistic achievement

-§117: exclusion for certain scholarships and fellowships

IV. Business Gifts

Commissioner v. Duberstein—Cadillac given by one business executive to another for thank you for passing along names of potential suppliers is compensation for services; SC rejects bright line rule IRS proposed (no such thing as a business gift); RULE—look to primary or dominant motive of transferor

- Courts look to detached and disinterested generosity v. moral or legal obligation/anticipation of future benefit

- Really a mixed motive transfer that Congress does not unscramble

Congressional Response

-§274—no such thing as a deductible business gift

-§102—no such thing as an employer/employee gift

V. Transfer Due to Divorce

A. Property Settlements

United States v. Davis—when TP transferred appreciated property to ex-wife as part of property settlement, realization occurred and TP must pay tax based on even exchange hypothesis

- Value of property is traded for release of claims, so value of release of claims is purchase price of property; as in trades, assume value of release was FMV of property

- Different tax treatment in common law and community property states because in common law states, wife's interest does not rise to level of co-ownership as TP in *Davis* argued

- Person receiving settlement is not taxed on receipt and gets FMV adjusted basis in property

- Different approach: *Raytheon*
 - Recipient couldn't sell marital rights to anyone else, so hard to view as a marital transaction
 - In lieu of what were damages received? In kind support, loss of consortium, love, etc or elective share then no income tax
 - Fact that recipient gets FMV basis consistent with idea that received in lieu of elective share because get FMV basis when receive bequest, devise or inheritance

Congressional response §1041

- No gain or loss recognized when transfer of appreciated property to spouse or former spouse if incident to a divorce and if transfer occurs within one year
- Recipient gets carryover basis per §1041(b)—property treated as if acquired by gift
- Non-recognition is deferral and shifting of liability from higher to lower bracket

Farid-Es-Sultoneh v. Commissioner—holding, that TP takes a basis of FMV of stock on date of receipt for stock received under premarital settlement, is flip side of *Davis* case; realization even occurred because stock used to buy release of wife's future claims

- IRS took position in §1041, which is the law today

B. Spousal Support

Old rule: alimony was received tax-free under *Raytheon* because replacement for in-kind support that would have been tax free

New rule: §71—alimony as defined for tax purposes is gross income for payee but deductible by payor

- Definition of alimony changed in 1984 from definition depending on state family law and intent of parties to bright line rule emphasizing form over substance

Alimony recapture rule—§ 71(f): sudden decline in amount of cash payments leads to reversal of tax treatment

C. Summary of Rules

- Distinction between alimony and property settlements
 - Payment in cash that also meets other 4 requirements for definition of alimony: payor can deduct under §215 and payee includes under §71(a)
 - Property settlement: no deduction for payor and no inclusion by payee, but only carryover basis per §1041(b)(2)
 - Child support: no deduction for payor, no inclusion for payee

Business and Investment Expenses

I. Major Case

Welch v. Helverin—TP takes it upon himself to repay debts of corporation; no deduction because payments were not ordinary

Necessary—appropriate and helpful (relaxed standard);

Ordinary—common or typical in the business world

- Retrospectively, decision has been reinterpreted to say that problem was that payments were to acquire or improve good business reputation and consumption under §262

II. Education expenses

1. Skills maintenance—deductible—necessary, ordinary and business related under §162(a)
 2. Qualifies TP for new trade or business—expect to produce income over future years; not deductible now; §263 and §167
 3. Recreation/entertainment—not deductible per §262
- What about undergraduate education? Substantial investment, but are they cultural or business related

◦ Right approach in theory—ask which above category education cost in question fits into, but don't do it in fact

- Never allowed for amortization
- Skill set is not property according to income tax

III. Public Policy Disallowance

Commissioner v. Tellier—money spent to defend against criminal charge is deductible according to language of §162(a), but public policy disallows it; only make public policy exceptions when deduction “will undercut a sharply defined public policy”

Congressional response:

- §162(c)—no deduction under (a) for bribes and similar payments to government officials; burden of proof is on government
- §162(e)—no deduction under (a) for bribes, kickbacks, or other criminally illegal payment under federal law or any state law; no deduction for influencing legislation, campaigning, etc. unless to local government
- §162(f)—no deduction under (a) for fines and penalties paid to government for violation of any law
- §162(g)—in any criminal proceeding, if convicted of anti-trust laws or pleads no contest, then no deduction for 2/3 of treble damages (fine or penalty in substance)
- §280E—disallowance for cost of drug dealers business expenses

Mazzei—deduction is allowed under §165 in bogus counterfeiting scheme; even though Congress spoke, court held courts can make exceptions outside of §162

Dissent—hard to frustrate national policy against counterfeiting when the whole thing was fraud anyway

IV. Capital Expenditures

A. General rule

- Ordinary repairs are deductible as a business expense under §162(a)
- Substantial improvements or betterment are not deductible under §263—producing income over many future years; don't deduct now but get cost recovery later

Mt. Morris Drive-In Theatre Co. v. Commissioner—costs of drain system constructed under threat of litigation is not deductible because it extends economic life of property;

KEY QUESTION: Does this extend the period in which business will be useful? If economic life of property extended?

Other Rationales:

- Actually purchasing a flowage easement, which would have been a taxable expenditure
- Also, under *Raytheon* damages are in lieu of building drainage system in the first place, which would have been taxable expenditure

Commissioner v. Idaho Power Co.— despite §167, §263 allows no deduction for depreciation because trucks are being used to build new power lines or distribution facilities, so while they are wearing out over 7 years, they are used to construct property that will produce income for 30 or 40 years;

- Purpose of §263 is matching of costs of earning income with income being produced
- Principle ground for decision—ECONOMIC NEUTRALITY
 - Co. had a choice—could have paid another company to construct new distribution centers
 - Cost to Co. would include fact that construction company had transportation equipment that was wearing out
 - Shouldn't be entitled to deduct it now if you do it yourself; no tax based distinction between doing construction yourself or hiring construction company

- To treat them the same, have to realize that using up trucks is an indirect cost of assets and must go into basis of assets
- Statute contains resolution for this situation--§161 and §261 of the code
 - §161 says deductions are allowed subject to statutory exceptions
 - §261 says no deduction allowed with respect to items in this party
 - So, no ambiguity—disallowance provision prevails when there is competition
- B. Capital Expenditure Cost Recovery
 - Eventually have to give you back tax free your tax paid investment to make sure we're only taxing gains or enrichment
 - §263 says no deduction now, but if it applies you get a basis increase in one of two ways
 - Maybe §1012—cost basis; Mt. Morris Drive-In—effectively purchasing new long lived drainage system, so get cost basis
 - Maybe §1016(a)(1); when build addition to factory to increase production no cost basis because not a separate item of property; “proper adjustments shall in cases be made for expenditures properly chargeable to capital accounts” = increase in basis by amount spent to make addition
 - Cost recovery occurs in one of 3 ways
 - Property wears out through use or over time, then entitled to depreciation or amortization deduction; see §167(a) which works in conjunction with §1016(a)(2)
 - If property doesn't wear out over time, then get a basis offset on sale under §1001(a); adjusted basis is a running tally of tax paid investment in property
 - When you sell property you don't get enough back, then loss deduction under §165(a) and (c); don't get investment back tax free, then entitled to deduct loss and free up other income from tax
 - §263 says its not the right time to tax now—proper timing for income and the costs of producing; increase basis so give you tax paid investment back tax free later

Mixed Motive/Dual Purpose Expenses

- Consumption is the core of the tax base and must be protected
- Some personal element and business related to some degree
- I. Child Care
 - Henry Smith*—child care is inherently a family expense that is non-deductible under §262
 - Language of §162
 - Deduction for ordinary or necessary expenses paid or incurred in carrying on a business
 - “Paid/incurred” goes to types of accounting methods
 - “Carrying on”—when mom paid costs, was she carrying on her business? Connotes expense that advances business or helps make a buck; didn't make her more valuable to employer but was a necessary adjustment to personal affairs to make her available to hold a job
 - If not allowable under §162, then don't get to §262—may be technical basis for court's decision
 - Does it make any sense as a matter of tax policy to hold that child care costs are not deductible?
 - Depends on TP
 - If woman is career woman and then decided to have children, then having children is personal expense
 - If working mother is a mom first, then change in circumstances so have to get a job, then first commitment is to kids and family so have to do something about personal obligations

-BUT, Can't do this inquiry feasibly, so have an all or nothing rule

II. Work Clothes

Pevsner—clothes worn in retail store and required for job are not deductible because clothing is inherently a personal expense

- SC thinks §262 imposes general rules about what is consumption
- Uniforms that are not usable off the job are deductible

III. Business Travel

- Travel to or from work?

-NO deduction—"Carrying on" problem

-Only an adjustment in personal life to put position to earn money not advancing employment

-Contemporaneous conduction of business doesn't make travel deductible, but cell phone costs are deductible

-Another rationale: as a matter of tax policy is a function of where you choose to live, but assumes job location is variable and residence is fixed

- Cost of travel/meals/lodging while in DC for 1 week

-Costs are deductible because "traveling expenses including amounts expended for meals and lodging while away from home in pursuit of trade or business" §162(a)(2)

-Shelter is usually consumption, but housing is over and above what she is already paying; this expense duplicates her costs and is necessary only because of business

-Meals are duplication—rule should be that meals are deductible to extent you can show they exceed the amount you would spend at home

-Excess meals costs rule calls for TP by TP analysis, which led treasury to beg Congress to allow a deduction for everything

- See §274(n)(1)—amount allowable for deduction for any expense for food or beverage shall not exceed 50 cents on the dollar

-Only get to deduct ½ of meals

-Partial disallowance rule that is bright line, objective and easy to administer

- Travel and meals—DC for 1 day

-Cost of travel is deductible but meal is not deductible

-SC has interpreted "away from home" to mean "while away from home overnight"

-BUT—means she can't deduct transportation costs or meal costs

-Use *Old Colony* analysis: have to go to DC during the way; could have gone to Philly office first then driven to DC, which is deductible because no personal component to transportation costs between two business locations

1 year bright line rule: when told to go to DC did you anticipate you had to be there for more than 1 year? If yes, then no deduction because reasonable person would move

-Depends upon prediction at time you move to temporary job site—TPs in situations where things change

-See §162(a) flush language after (1)-(3)—TP shall not be treated as being temporarily away from home if such period exceeds one year; Congress to hell with prediction, if employment is a year and a day, then no costs are deducted

- Daily travel to Philly or DC when DC business becomes so substantial that she lives in Baltimore

-Personal choice to move to Baltimore motivated by business considerations

-NOT deductible, just a long commute even though total transportation costs and mileage are the same

- Concorde to Europe

- “Lavish or extravagant under the circumstances”
- Applies only to meals or lodging, but Concorde is transportation
- 274(k)—lavish or extravagant limitation for all business meals, not just overnight trips
- 274(m)—lavish or extravagant limitation for transportation—only a cruise ship rule

IV. Deductibility of Legal Expenses

United States v. Gilmore—other side of *Raytheon*—appropriate tax treatment of payor of damages;
As to payor, or expenses of defending litigation, test depends upon origin of the claim—personal or business

- §212—does not directly say carrying on, but court reads in a carrying on requirement