I. STATUTORY INTERPRETATION
The Internal Revenue Code (IRC), Title 26 of US Code, is the most comprehensive, confusing and difficult statute ever devised by mankind. It requires more from more individuals in the way of compliance people than does any other statute, however there is no definition of “individual.”

A. The Steps of Statutory Interpretation:

1) **Follow All Cross References**: First, follow all cross references within the statutory section.

2) **Look for Statutory Definitions**: Second, look for statutory definitions: a) Locally, meaning within the same section; b) Globally or throughout the entire Code or in §7701.

   a) **Statutory Exclusion**: Term at issue may have been intentionally excluded.

3) **Resort to The Rule of Statutory Interpretation**: If no definition exists, then absent contrary statutory interpretation, the legislature probably intended for the statutory term to be understood according to common usage. Also, use negative implication to find meaning. However, common usage should not defeat precedent, legislative history or purpose. Otherwise, precedent, legislative history or purpose prevails.

   a) **Precedent**: Look to prior case law and the persuasiveness of the term in another area.

   b) **Legislative History**: Look to legislative history.

   c) **Purpose**: Look to the policy behind the statute. For example, definition of “essential” with regards to government function requires knowledge of the Principal of Intergovernmental Tax Immunity which is the embodiment of federalism, whereby we don’t want governments interfering with each other. If the purpose of the statute

II. TAX POLICY
Federal tax policy and tax provisions are guided, influenced and constructed by three main concerns: revenue generation, economic progress and distributive justice.

A. Revenue Generation: The principal motive behind the federal income tax is getting funds to pay for society. This consideration falls primarily within the expertise of the economist. But revenue generation is only one concern, without the considerations of economic progress and distributive justice, the government could rely on uncompensated expropriation or printing money (“The most feathers for the least squawking”). There are three criteria that make-up the consideration of revenue generation.

1) **Revenue Effects**: In deciding if a policy generates revenue, Congress must consider if the tax provision causes a gain or a loss in tax receipts

   a) **Limitations to Loss of Tax Revenue**: Congress intended to tax beneficiaries of income, not necessarily the person who has title. The assignment of income doctrine incorporates common law notions of taxation.

      • **The Kiddie Tax**: To prevent parents from putting unearned income in children’s name, §1(g) or the “Kiddie Tax” taxes children’s unearned income at parents’ rate.

      **Earned Income**: Earned income is compensation for services.
      **Unearned Income**: Unearned income is income from property.
      **Unearned income** portion of AGI
2) **Administrative Convenience, Efficiency & Practicality**: Congress must also consider if the tax provision permits low-cost enforcement.

3) **Taxpayer Compliance**: Congress must also consider if the provision minimizes TP dissatisfaction by limiting record-keeping and reporting costs, constrains administrative discretion, promotes simplicity, promotes convenience in the timing of tax liabilities and appears fair.

**B. Economic Progress**: As with revenue generation, economic progress also falls primarily within the ambit of the economist. Three criteria make-up consideration of a provision’s effect on economic resources.

1) **Economic Neutrality**: Economic Neutrality is concerned with whether the provision causes tax-induced changes in people’s utilization of economic resources. If the provision causes a change in people’s allocation of economic resources and thus induces TPs to behave differently with the tax than they would in a no-tax world, then the provision is not economically neutral. Economic Neutrality contends that tax provisions should interfere as little as possible with TPs economic decision-making. TPs should not decide work over leisure, to spend or to save, to consume or to invest because of a tax provision(s). In a free-market system, tax provisions should not distort decisions – they should only **minimally** interfere with economic decisions.

   a) **Capital Lock-In**: Concern for economic neutrality is manifested in measures to mitigate “Capital Lock-In.”

   b) **Labor Lock-In**: Another thrust of economic neutrality is the concern over “Labor Lock-In” resulting from the tax-free status of imputed income.

2) **Economic Growth**: Economic growth is concerned with whether the provision promotes or retards economic growth.

3) **Economic Stability**: Economic stability is concerned with whether the provision ameliorates or exacerbates fluctuations in business and economic cycles. During periods of economic growth, a provision which bears down hard on TPs can reduce inflationary pressure by taking purchasing power out of the hands of TP. During periods of economic recession, provisions which leave more money in the hands of TP can prop up consumer spending. However, a decrease in taxes can also lead to annual deficits.

   a) **“Automatic Stabilizer”**: The progressive rate schedule of the IRC is considered to be an automatic stabilizer because personal income increases during periods of economic growth but decline during recession.

**C. Distributive Justice/Fairness**: A third consideration of tax policy is distributive justice. The tax system must be consistent with the country’s institutional arrangements and societal aspirations reflected in both a democratic political system and a free-market economic system. It must also respond to society’s concept of fairness. Overall, tax policy must fairly distribute the burdens of supporting the government.

1) **Vertical Equity**: Vertical Equity is a criteria of distributive justice that is concerned with whether the provision maintains or promotes differences in tax burdens between TPs in differing circumstances. Some argue that vertical equity criteria makes up for non-progressive characteristics in other tax systems, such as the sales tax.

   a) **Progressive Tax**: The IRC rate schedule is a progressive income tax: TPs’ proportion of tax or tax rate increases as income increases – not the tax. This is widely held to be the most just. Furthermore, with the progressive tax, higher rates only apply to marginal-
additional income. There is a problem with declining utility with a progressive tax, however; income may be less desirable when taxed more (the “Price Effect”). However, income may be even more desirable because the income tax is taking income away so TP wants to work hard to replace the lost income (the “Income Effect”).

**OR**

b) **Regressive Tax**: A regressive income tax is a tax system in which TP’s proportion of tax or tax rate decreases as income increases. This may violate vertical equity and could nonetheless still force the wealthier to pay more as income increases (smaller percentage but of larger income).

**OR**

c) **Proportional (“Flat”) Tax**: A proportional tax is a tax which all TPs are taxed at the same rate, effectively all paying the same portion of their income in tax. The sales tax is a proportional tax.

**OR**

d) **Head Tax**: A head tax requires that everyone pay one flat fee to support the government. But this is unacceptable and “criminally unfair” according to vertical equity.

2) **Horizontal Equity**: Horizontal Equity is a criteria of distributive justice that is concerned with whether the provision maintains or promotes differences in tax burdens between TPs in similar circumstances. Horizontal equity demands that two TPs that have the same income pay the same tax regardless of the source of that income. “Gross income means all income from whatever source derived.”

3) **Transitional Equity**: Transitional Equity is a criteria concerned with whether the provision provides safeguards against reliance interests and prevents windfall gains and losses.

**D. Congressional Self-Interest**: Sometimes Congress just wants to keep its job.

**III. JURISDICTIONAL BASIS**
There are three independently sufficient grounds for the jurisdiction of the Federal Income Tax.

**A. Citizenship**: Citizenship is uniformly accepted; citizens get benefits so it’s fair to require them to pay. The US is one of only two countries, in addition to Liberia, that has jurisdiction based on citizenship.

**B. Residence**: Like citizens, it is generally agreed upon that residents derive benefits so it’s fair to requisite them to pay. As for non-resident aliens, they derive economic benefits. §877 prevents the wealthy – or anyone – from expatriating so as to avoid tax liability.

**C. Source**: US citizens are taxable on worldwide income. The justification is that US citizens have a voice and diplomatic representation.

1) **International Agreements**: Agreements and treaties prevent the US and other countries from overtaxing citizens. For example, they prevent the US, France and Canada from all taxing one individual 40% each.

2) **Unilateral Statutory Rules**: Unilateral Statutory Rules also deal with other countries claims. If the US does not have a treaty with a certain economy or country, then the US allows a deduction or a credit, essentially considering such payment to be a withholding tax. The US unilaterally extends a 100% foreign tax credit, thus the US’ tax rate will never be any higher than the other country’s tax rate and so as to not destroy international trade.
IV. TAX COMPUTATION

**STEP 1**

**Gross Receipts:** All items of value received, money, property or services.
- **Loan Proceeds** (Principal Amount of Loan)
- **Basis** (Costs of Goods Sold)

**Gross Income**

**STEP 2**

**Gross Income:** §61(a): “Gross income means all income from whatever source derived…” 101-139).
- **Exclusions**, §§101-139 Exclusions are more like non-itemized deductions and usually refer to “money coming in” like meals and lodging, ER premiums (excludable)
- **Non-Itemized Deductions**, §62(a) Lists these are costs of producing income and also considered “Above-the-line Deductions” and are deductions allowed because they “are attributable to a trade or business carried on by the taxpayer” and are business expenses but do not include unreimbursed expenses of employees. Costs of Producing Income are generally born by ERs. Non-Itemized deductions include loss from sale or exchange of property and alimony payments. Salary and wages are essentially Net Income by time EEs get it. § 63(d)(1) then says see IDs

**Adjusted Gross Income** (Also considered **Net Income** or **Economic Income**)

**STEP 3**

**Adjusted Gross Income:** §262(a): AGI or Net Income is the core of the tax base and does not allow deductions for consumption (personal, living or family expenses). Period.
- **Personal Exemptions**, §63(b), §151 (allowed to all taxpayers regardless of deductions) AND
  - **Standard Deduction**, §63(b) (Standard Deduction promotes administrative efficiency, most use the SD, about 60%of returns use the standard deduction; Secondly, Standard Deduction along with Personal Exemption is an amount not subject to tax) OR
  - **Itemized Deductions**, §§162-198, 211-223, 241-249. (Itemized Deductions are usually for mortgage interest, property taxes, charitable contributions, etc., often benefiting homeowners and often refer to “money going out”). The role and value of a deduction is that the amount you save is dependent on your tax rate, thus helping those of higher income. §164, for example, makes state and local taxes deductible. (§§261-280 specifically mentions **Items Not Deductible**). §275 excludes deductibility of FIT because we would then need to increase nominal rates to increase tax liability.

**Taxable Income**, §63

**STEP 4**

**Taxable Income**, §63: This is the Tax Base

**X** The Appropriate Rate

**Tax Imposed**, §1 or §3

**STEP 5**

**Tax Imposed**, §1 or §3
- **Credit** §§21-53, (If the credit is more than the tax imposed, then it may be a **refundable credit**, §§31-35 which means TP gets from the government the Credit – Tax, such as taxes withheld or EIC; or it may be **nonrefundable**, §§21-30A, meaning TP does not get the difference). The value of a credit is fixed, unlike a deduction.

**Tax Due**
V. THE SCOPE OF GROSS INCOME

§61(a) states: “[G]ross income means all income from whatever source derived….” However, not all types of income could possibly be enumerated.

A. Income In-Kind: Income in-kind is income from property, services or other benefits that are receipts in some form other than cash. Furthermore, it can be from an irregular or unexpected receipt. If it satisfies certain provision, income in-kind is excludible from §61 gross income.

1) Discharge of an Obligation by Third Party: The discharge of an obligation by a third party is income. [Old Colony Trust Co. v. Commissioner 279 U.S. 716 (1929): Employer paid employee, Wood, a salary of $978K in 1918 and $548K in 1919, for which ER directly paid EE’s income taxes for both years, $681K in 1919 (for 1918) and $351K in 1920 (for 1919) to the Government, thus EE’s salary would be EE’s net income. Held: The payment by ER of the income taxes constitutes additional income to the EE.] In Old Colony, payment by third party of non-deductible federal income taxes is taxable to EE. Federal Income Taxes are not deductible, otherwise we would need to greatly increase nominal rates to get the same amount from the same TP.

a) Economically Equivalent Test: If two (or more) step transaction is economically equivalent to one step transaction, both must be taxed similarly. [Old Colony: Payment by ER to IRS was economically equivalent of payment by ER to EE and then from EE to IRS. “The discharge of an obligation to him is equivalent to receipt by the person taxed.” In both cases, whether from ER to EE or from ER to IRS, it’s economically equivalent and was enrichment to EE.] Substantive Over Formal.

i) Policy Rationale for Economically Equivalent Test: The Economically Equivalent Test: a) Promotes Economic Neutrality because lack of such a test would lead to “hideous” tax evasion in the form of whereby ER would pay most compensation to the EE’s creditor; 2) Promotes Horizontal Equality whereby individuals in similar circumstances would not be treated differently because one has an ER who will pay EE’s bills and the other doesn’t.

ii) Statutory Interpretation and Economically Equivalent Test: Even though common usage may exclude economically equivalent payment from tax, Old Colony looks to purpose and concludes that tax system should not be based on EE’s ability to negotiate with ER. Purpose triumphs over common usage.

2) Employment-Related Exclusions: There are certain forms of payment that are excluded from gross income.

a) Meals and Lodging: §119: Meals and Lodging are excludable. The History:

1937: Convenience of the Employer: Business Necessity: In-kind benefits provided for the convenience of the ER are not gross income to EE, and thus not taxable. [Arthur Benaglia: (1937): EE worked in a posh Hawaii resort and in addition to EE’s salary, ER provided to EE: 1) a suite of rooms in the hotel and 2) meals at the hotel. Held, Meals and lodging (In-kind benefits) provided for the convenience of the ER are not income to the EE. Dissent: Meals and lodging were intended to be compensation to the ER, as exemplified by contract and by understanding between ER and EE]. Convenience of ER means business necessity, otherwise EE could not have performed the services required of him. For Benaglia, other ways to tax? 1) No tax on Rental Price because that would be overtaxation; 2) No tax on Expenses avoided because administratively impossible to determine; 3) No tax on Subjective value because it can’t be done consistently to all TPs; 4) No tax on Alternative Arrangements because it would lead to a disparity among TPs; 5) No tax on Cost to ER because we want to tax enrichment to EE, not cost to ER.
1950-1954: Lower Court and IRS Limitations: IRS and some courts move to limit convenience doctrine exclusion, claiming that despite the business necessity, if the benefit or the item is intended as compensation to EE, then it is not excludible from gross income. [Doran v. Commissioner: (1953): Held, EE’s rental allowance was for the convenience of the ER, but also as compensation to EE].

1954: Congressional Codification: §119 enacted to codify treatment of ER provided meals and lodging. §119(b)(1) negates whether ER and EE intended for the benefit to be compensation. Thus intentions are no longer important.

1956 (to Present): Treasury Regulations: Treas. Reg. §1.119-1 interprets the §119 requirements for exclusion:

i) Convenience of Employer: §119-1(a)(2): Convenience of the ER means the meals are “furnished for a substantial noncompensatory business reason of the ER.”

ii) Business Premises of Employer: §119-1(c)(1): “The place of employment of the EE.”

iii) When There is Requirement of Lodging: §119-1(b)(3): Excludable if it: 1) is for convenience of the ER, 2) on business premises of EE and “EE is required to accept in order to enable him to properly perform duties of his employment.” [President includes White House in gross income, excludes value (??what is value??); WashU President excludes University home from gross income.]

1977: Supreme Court Limitation: The Supreme Court interprets and limits §119 requirements for exclusion. [Commissioner v. Kowalski 434 U.S. 77 (1977): Instead of returning to the barracks during lunch thereby causing a hiatus of police coverage on the highways, New Jersey state troopers were given a cash meal allowance so they could eat in restaurants while working. Held, 1) The meal allowances must be taxable income because there was accession to wealth and dominion over the cash meal allowances; 2) In Kowalski the troopers got cash, not a hotel and meals like in Benaglia; 3) Regardless of Benaglia, the cash meal allowance was not necessary. Kowalski adopts a very stringent interpretation of business necessity. Dissent, cash meal allowances are income but excludable because they are on the premises of the ER, §119 should not be construed so strictly.]

i) Convenience of the Employer: “Business Necessity” as had been used in Benaglia. [Kowalski: Meals were not business necessity, essentially the state could have just provided box lunches.]

ii) Business Premises: ???

iii) Condition of Employment: ???

1978: Congress Responds to Supreme Court: Congress adds §119(b)(2) and (3) and makes the provision retroactive to 1954, essentially relaxing the term “convenience of ER.”

§119(a)(1): Essentially In Kind meals.

added in 1978:

§119(b)(2): Meals for which there is a charge will be excluded from gross income and furthermore, the provision negates the importance of whether EE had a choice over meals. (Provision says just because there was a charge or employee choice, doesn’t mean not excludable).
§119(b)(3) excludes from gross income cash payments for meals ("required...fixed charge...for meals.")

In §119(b)(3), TP is getting a fixed charge, while in §119(a) TP is getting in kind meals. Congress believes their relaxed interpretation leads to horizontal equity – TPs in similar situation will be able to exclude income, taxed similarly for constrained consumption. Congress is really pissed at Supreme Court for judge-made exceptions in Kowalski. IRS had done its job with 1954 regulations (because it must answer to Congress) but Kowalski life-tenure judges don’t answer to Congress and had gone against the law in Kowalski. Congress firmly believes NJ state troopers should have been able to deduct cash meal allowances and Supreme Court decision was insultingly wrong. So even though the statute of limitations was 3 years and thus few TPs would benefit from retroactive tax benefit to 1954, Congress wanted to make a statement. [Sibla v. Commissioner: 611 F.2d 1260 (9th Cir. 1980): To encourage integration, LA fire department mandated that firefighters eat together. The Fire Department provided the facilities but the firemen provided food and supplies, costing the firemen fees of about $3/day. Firemen wanted to either deduct the value of the food from their income or exclude the value of the food from income. Held, firemen may choose to either: 1) deduct the mess fees under §162(a) as a business expense; or 2) exclude the mess fees from gross income under §119. Dissent, TPs had tremendous “freedom” on how to eat.] But regardless of what the 9th Circuits states, §119(b)(3) should not apply to Sibla because there was not a fixed price for the meals paid for by the firemen.

i) Policy Problems with Convenience of the ER Doctrine: The convenience of the Employer has two fundamental policy problems. a) Violation of Horizontal Equality by treating two TPs who earn the same amount differently, e.g., a mechanical engineer making $48K and a hotel employee making $48K with $18K in free meals. b) Violation of Economic Neutrality: Hotel industry can lower salaries because they can “pay” with meals and lodging and because salaries are lower, hotel can lower prices.

ii) Non-Employment Related In-Kind Benefits: Unlike in an employment situation, where Congress recognizes convenience of the employer, in non-employment situations income in-kind is enrichment and includible. [Reginald Turner: Husband and Wife receive tickets to Buenos Aires on a steamship, trade tickets in for four tickets to Rio de Janeiro. Held, Non-employment situation, non-transferable benefit of free board, savings in living expenses and pleasure of trip was indeed income.] [Haverly v. United States (1975): Schoolteacher received $400 worth of unsolicited textbooks, donated them and took $400 deduction. Held, Deduction for donation of unsolicited samples, value of samples received must be included in TP’s gross income. However, IRS is not claiming that unsolicited samples are includible in income, because of prosecutorial discretion. Yet when TP claims deduction on books, they’re income].

b) Parsonage Lodging/Parsonage Allowance: The lodgings of a “minister of the gospel” (the word minister is interpreted flexibly and incorporates many religions) are excludable from gross income under §107.

Treas. Reg. §1.107-1(a): “duties of a minister...include the performance of sacerdotal functions, the conduct of religious worship, etc.”

The §107 provision dates to 1920, thus older than Benaglia and does not grow out of the convenience of the employer doctrine.

§107(1): Rental value of home furnished is excludable from the “minister’s” gross income. – OR –

§107(2): Rental allowance paid to minister is excludable.
i) **Farm is Not Excludable**: The minister is not allowed to exclude the value of the farm or rental allowance for the farm – just the “home.”

Treas. Reg. §1.107-1(c): “The portion of the rental allowance expended in connection with the farm or business property shall not be excluded from his gross income.”

ii) **Fair Rental Value**: The minister is not allowed to deduct more than the fair rental value.

§107(2): Excludable only so much as the “allowance does not exceed the fair rental value of the home.”

Thus, as limited by §262, personal, living or family expenses not excludable.

c) **Fringe Benefits**: §132 and §117(d), In addition to meals, lodging, and parsonage lodging, certain fringe benefits are also excludable from gross income. These benefits are not dealt with through the business necessity doctrine of *Benaglia* because §119 in 1954 was meant to deal with meals and lodging and “certain fringe benefits” are not meals nor lodging. Furthermore, “except as otherwise provided” in the IRC, you pay tax on the benefit. So Congress created these provisions in 1984 to allow the exclusion of certain fringe benefits from gross income.

i) **Policy Rationale for Exclusion of Fringe Benefits**: Congress recognized that there are valid business objections to be served by allowing an employee a discount for goods or products, for example a retail business allowing employees to wear the retailer’s clothes at a discount. Congress recognized that these type of benefits were not necessarily intended as compensation.

Treas. Reg. §132-1: **Definition of Employee**: Partners, spouses, etc.

§132(a): listing of that which is excluded from gross income:

1. §132(b): **No Additional Cost Service**: A no additional cost service means any service provided by the employer which basically won’t cost the ER any more to provide to the EE, like free stand-by flights to airline EEs.

2. §132(c): **Qualified Employee Discount**: A qualified EE discount is sale of ER merchandise to EE. Limitations:

   §132(c)(1)(A): **Property**: Discount cannot exceed the gross profit percentage of price ER offers to customers. Gross profit percentage means:
   
   
   
   $\frac{\text{Aggregate Product Sales Price – Aggregate Product Cost Price}}{\text{Aggregate Product Sale Price}}$
   
   §132(c)(1)(B): **Services**: Discount cannot exceed 20% of price ER offers to customers.

3. §132(d): **Working Condition Fringe**: A working condition fringe is parking facilities, security guard transportation or anything that would be §162 business deduction or §167 depreciation deduction.

   Treas. Reg. §1.132-5: 6 conditions to be met.

4. §132(e): **De Minimis Fringe**: A de minimis fringe is a fringe that is “so small that to make accounting for it unreasonable or administratively impracticible” like occasional dinner money, company picnics and taxi-fare.

   Treas. Reg. §1.132-6(d)(2)(i): benefit must be on an occasional basis

5. §132(f): **Qualified Transportation Fringe**: A qualified
transportation fringe is a fringe like a subway pass or ride in a “commuter highway vehicle.”

(6) §132(g): **Qualified Moving Expense Reimbursement**: A qualified moving expense reimbursement is one which would also be a §217 moving expense.

– OR –

(7) §132(m): **Qualified Retirement Planning Services**: Qualified retirement planning services means advice on retirement.

(8) §117(d): **Qualified Tuition Reduction**: A qualified tuition reduction is a reduction in tuition for an employee of a §170(b)(1)(A)(ii) institution.

§132(h): Spouse and dependent children treated as EEs for (1) and (2) of §132. (For a no additional cost service exclusion and for a qualified EE discount exclusion).

ii) **Boundaries for Exclusion of Fringe Benefits**: Congress wanted boundaries to: a) **Promote Taxpayer Compliance** by preventing “tax shifting” and other practices that allow HCEs to avoid creating taxable income, thus shrinking the country’s tax base; 2) **Promote Fairness** whereby when there is compliance from the masses – both HCEs and NHCEs must pay or not pay together and thus HCEs cannot escape liability while the poorer pay.

§132(j)(1): **Non-Discrimination Rule**: For a no additional cost service exclusion and for a qualified employee discount exclusion, HCE’s cannot benefit unless: 1) the benefit is offered on substantially the same terms to all groups of EEs; 2) classification cannot discriminate in favor of HCEs. The classification does not discriminate in favor of NHCEs if:

\[
\frac{\text{Portion of NHCEs Receiving Fringe}}{\text{Portion of HCEs Receiving Fringe}} \geq 70\%
\]

If TP violates the Non-Discrimination Rule, then that fringe benefit is taxable to TP.

§132(j)(6): **Highly Compensated Employees**: (§414(q) A highly compensated employee is one who: 1) Owns more than 5% of the ER; 2) Earns more than $80K in total compensation.

B. Imputed Income: Imputed Income is a form of income in-kind that results from consumption or investment for one’s own use or ones’ family use. But unlike the other forms of income in-kind which may be excludable after satisfying certain provisions, imputed income is always excludable from §61 gross income. Though not excludable by any specific provision, there has never been any real attempt to tax imputed income and the policy continues because of long-standing administrative practice.

1) **Imputed Rent from Property**: Imputed income from property means the benefit the owner receives from the property. a) The owner of an owner-occupied house certainly receives a benefit from living in the house, however TP is not taxed on the benefit (“imputed rent”) TP receives yet if another party lived in the house and paid rent to TP, the rent to TP would be §61 gross income. b) Furthermore, TP can deduct mortgage and real estate taxes for further benefit, yet the tenant cannot deduct rental payments.
i) **Policy Problems with Exclusion of Imputed Rent**: Because imputed rent is excluded from §61 gross income, several implications arise. 

a) **Violation of Horizontal Equality**: Two TPs living in similar homes and getting similar benefit from the home are taxed differently.

b) **Violation of Economic Neutrality**: As a consequence of the tax-free status of imputed income, Americans overinvest in their homes rather than investing in other options such as production or education. The United States is the biggest investor of any developing country in owner-occupied housing. Sprawl and other problems also arise.

ii) **Policy Problems with Alternatives to Exclusion of Imputed Rent**: To overcome the violations of horizontal equality and of economic neutrality which arise from the exclusion of imputed income, there are two implausible alternatives.

- **Tax Both**: To tax both, the homeowner would be taxed on the value of the benefit received from the house while the tenant would continue to be unable to deduct his rental payments. This alternative would encounter fierce opposition from homeowners.

  - **OR**

- **Tax Neither**: To tax neither, then the tenant’s rental payments would be allowed to be deducted from AGI.

  a) **Loss of Revenue**: The Government would lose a substantial amount of revenue that it currently can tax.

  b) **Violation of Economic Neutrality**: Renters would overinvest in housing and the economic distortion which already exists would be exacerbated and made worse.

2) **Imputed Income from Services**: Imputed Income from property means the benefit TP receives from services within the household, such as caring for the home, preparing meals and educating children. Though these services are available on the market, TP will not include in gross income the benefit received from these services when TP does the services for themself.

i) **Policy Problems with Exclusion of Imputed Income from Services**: With regard to household services, for example, TP will need to be paid enough so that after tax income will be as much or more than the tax free services TP renders without a job. This is a **Violation of Economic Neutrality**: There is a tremendous misallocation of financial and labor resources. TP could work and there is market for TPs service but TP will not work.

**Solution to Violation of Economic Neutrality**: There is a provision which provides a credit for household and care services so that homemaker can work.

- **§21: Credit for Household and Childcare**: provides a credit for a percentage of the expenditures provided for child and household care. The value is independent of income level and **Promotes Vertical Equality** because lower income individuals get tax relief.

3) **Imputed Income from Leisure**: If TP takes a less demanding job which effectively reduces TP’s gross income, TP may actually benefit with an increase in leisure. Yet the benefit to TP is excludable from gross income.

4) **Imputed Income from Barter Exchange**: Barter imputed income is the income or benefit received in a bartered marketplace transaction. Just because it’s not cash, it is still income. When these benefits are exchanged within the household, however, they excludable from gross income.

**Treas. Reg. §1.61-1**: “Gross Income means all income…money, property or services.”

**Treas. Reg. §1.61-2(d)(1): Compensation Paid Other Than in Cash**: Barter is income.

i) **Policy Problems with Barter**: Because of **Taxpayer Compliance**, IRS rarely attempts to tax income in barter, for example carpool. Only if rampant abuse or significant value at stake will the IRS go after, for example doctors serving doctors.
C. Compensatory Receipts: Compensatory Receipts are income for damages suffered.

1) **The Raytheon Replacement Rule**: The Raytheon Replacement Rule assesses whether income is taxable by considering “In lieu of what were the damages received.” [Raytheon Production Corp. v. Commissioner: 144 F.2d 110 (1st Cir.) (1944): Raytheon brought suit against RCA for antitrust violations. Raytheon had created a sizable goodwill and customer base for the sale of rectifying tubes that Raytheon claimed was worth $3M in its present and future value. Eventually RCA agreed to pay Raytheon a $410K settlement as long as Raytheon would drop the suit and also hand over the patent rights to RCA. Raytheon considered $60K to be payment for the patents and included the $60K as gross income, but considered $350K to be compensation for loss of capital. *Held*, the damage payment of $350K represents a return of capital that would have been taxable income. The **damages were received in lieu of** return of capital or good will. Raytheon’s gross income: $350K Compensation – Cost of the Good Will (Basis). This was a forced sale, yet we don’t know the value of the basis. The burden is on TP Raytheon to report (§7491).

a) **Compensation for Lost Profits**: Damages for lost profits should be treated like ordinary income because they are in lieu of ordinary income. They are §61(a)(1) compensation for services. Thus compensation for breach of an employment contract is taxable. [Raytheon: The damages were not for lost profits because there was no more business. “This was not the sort of antitrust suit where the plaintiff’s business still exists and where the injury was merely for loss of profits.”]

b) **Compensation for Damaged Good Will**: Damages for destruction of good will should be treated like the proceeds from a voluntary sale or return of capital. For example, A’s $45K gain on Blackacre after spending initially $5K on it and recovering $50K from B in damages. [Raytheon: This was essentially a case where “RCA breaks it, RCA buys it.” As the court said, “The suit was to recover damages for the destruction of the business and good will.”]

c) **Compensation for Damage by Mistake**: When a third party causes liability, and then satisfies the liability, it is not taxable income. [Edward H. Clark: B.T.A. (1939): TP’s tax counsel advised TP and wife to file taxes jointly, for which they needed to pay $32,820.14. However, had the tax counsel advised the TP and wife properly, then TP and wife would have only needed to pay $12,879.04 ($19,941.10 less than what was actually assessed). So tax counsel paid TP $19,941.10 as damages. Government contended that counsel had just paid TP’s taxes and that it was the discharge of an obligation that TP would have otherwise paid and thus income. TP claims that this was compensation for tax counsel’s error and thus not income. *Held*, TP lost money which TP would not have otherwise lost due to counsel’s negligence. The $19K is compensation for the loss.]

d) **Compensation for Breach of Promise to Marry**: Compensation for the breach of a promise to marry is not taxable income because that which is replaced is imputed income, i.e., emotional distress, loss of consortium.

e) **Lost Wages and Future Wages**: Wages are certainly includable in gross income.

2) **Punitive Damages**: The Raytheon Replacement Rule does not apply to punitive damages. Nonetheless, such compensation is taxable, otherwise TP would be getting a windfall. [Commissioner v. Glenshaw Glass Co. 348 U.S. 426 (1955): Glenshaw Glass brought suit against Hartford-Empire Company for exemplary damages and for antitrust violations. In a settlement, Hartford agreed to pay Glenshaw $800K, of which $324K was for punitive damages and antitrust violations. Glenshaw did not report the $324 as income because Glenshaw claimed it was outside the scope of gross income. *Held*, punitive damages are within the scope of gross income, otherwise “Manna from Heaven.”]
a) **Statutory Interpretation and Punitive Damages**: Excluding punitive damages would go against the purpose of the Code. *Glenshaw Glass*: a) Congress may tax all gains except those specifically exempted; b) there is clear accession to wealth which is clearly realized over which the TP had complete dominion.] When Congress enacted the IRC, it was trying to use the full measure of its taxing power. The statute is as broad as Congress’ Constitutional Power.

3) **Medical Expenses and Pain and Suffering**: Compensation for Medical Expenses and Pain and Suffering are not taxable income. This does, though, stand-by the rule of *Glenshaw Glass*. Pain and suffering... replacing “psychic damages?” §104(a)(2): The amount of damages received for “personal physical injuries or physical sickness” is not includable in gross income.

a) **Policy Problems with Exclusion of Medical Payments and Pain & Suffering**: §104(a)(2) excludes personal physical injuries, however, it does not exclude personal mental injuries. This is a severe limitation, likely to be overruled by Supreme Court.

4) **Damage Payment and Debt Discharge Not Always Economically Equivalent**: In *Old Colony*, a third party’s payment of an obligation is income, yet in *Clark* the third party caused the liability. [*Clark*: “The measure of that loss, and the compensation therefor, was the sum of money which petitioner became legally obligated to and did pay because of that negligence. The fact that such obligation was for taxes is of no moment here.”] In *Clark* the damage was loss of capital.

a) **Tax Refund is Not Income**: If TP prepares his own return, making a mistake and paying too much FIT, the refund is not taxable income. Furthermore, TPs FIT payment is not deductible.

   i) **Policy Rationale for Exclusion of Refund**: §275: State and local taxes are deductible because TP would likely spend that money himself on the service if the state and local governments did not provide those services, such as trash pick-up. Thus, effectively state and local taxes are consumption, the TP is purchasing something from the state and local government. But FIT is not deductible because TP would likely not spend money on military as TP would spend to have his trash collected. Thus state and local tax refund are includable in gross income.

5) **Net Operating Loss CarryOver/Back**: With damages for breach of contract say, originally Congress had done a Tax on the Receipt-Side of No-Profit Transaction. *Burnet v. Sanford & Brooks Co.* 282 U.S. (1931): In a contract to dredge the Delaware River from 1914 to 1916, Sanford & Brooks spent $176K more in expenses than they made in profits, a net operating loss. (vs. a loss on self-dispossession of property or a casualty loss). S&B deducted those losses annually but regardless of the deduction, they did not have any income to deduct it from. In a 1920 recovery for breach of contract, S&B received $192K ($176K+ $16K interest) for lost expenses. S&B claimed that the payment was not gross income in 1920 but just a recovery for lost profits. Furthermore, the rate in 1920 was 77%. IRS claimed it was gross income in 1920. *Held*, such recovery by S&B in 1920 is includable in gross income for 1920. There should be a tax on the receipt-side of a no profit transaction: Administrative Practicality supports a tax on the receipt side because it’s a tax on income during the TP’s taxable year. Tax system cannot afford to wait until end of TP’s lifetime to get payment. §441(a): taxable income based on taxable year.

   Though TP has a sound policy argument, taxable year is from statute and statute is Constitutional. It would be too difficult to keep tax returns always open.

a) **Policy Problems with Tax on Receipt Side of No Profit Transaction**: Tax is based on Fairness, not practicality. Congress could impose a National Sales Tax to generate revenue, but that would not be as fair.
b) **Mitigation of S&B – Carryback and Carryover:** To assuage the unfairness inherent in *Sanford & Brooks* and thus the unfairness in the annual accounting principal, Congress enacted §172 for a deduction for net operating losses.

   §172(b)(1)(A)(i): **Carryback:** Losses incurred can be carried back up to 2 years preceding the loss.

   §172(b)(1)(A)(ii): **Carryover:** Losses incurred can be carried forward up to 20 years following the loss. [*Sanford & Brooks:* If §172 had existed for S&B, S&B would have been able to deduct the 1913-1916 $175K losses from the $175K gain in 1920].

6) **Loss on Sale of Property:** For recovery of the loss of property, tax on recovery if there was a tax benefit in previous year(s). [*Dobson v. Commissioner:* 320 U.S. 489 (1943): TP Dobson bought 300 shares of stock in 1929, sold 100 in 1930, deductible loss of $41K; sold 100 in 1931 and deductible loss of 28K, retained remaining 100 shares. However, seller had sold stock fraudulently, 1939 Dobson recovered settlement of $45K from seller: $23K attributable to the $41K loss in 1930, $6K to 1931 loss. Dobson: $29K is not income in 1939 it was a) a return of capital or b) if the $29K was income in 1939, it was income from capital gain, not ordinary gain. IRS: $29K is ordinary income in 1939, but $16K attributable to unsold 100 shares is not income.

   a) **Raytheon Damages Rule Partially Applicable:** Though Raytheon asks, “In lieu of what were the damages received?” the damages replace the purchase price. Thus because the 1929 purchases were made with after tax income, the 1939 replacement/refund should be tax-free. However, the Raytheon Rule only applies to the $16K of the unsold shares.

   b) **The Tax Benefit Rule:** Error Correction Device: If an item permits a deduction one year [*Dobson* 1930, 1931 loss in sale of stock] and then returns as profit, it’s taxable.

      i) **Inclusionary Side of TBR:** Rather than going back to the previous deduction, many years before, [8 years for Dobson] the inclusionary side of the TBR wipes away the previous erroneous deduction by taxing the income [*Dobson’s* 1939 gain of $29K] the year it is gained.

      **HOWEVER...**

      ii) **Exclusionary Side of TBR:** Tax Benefit Limitations: The exclusionary side of the TBR says we don’t try to correct harmless error in past by taxing income if there was no economic benefit (tax benefit) even derived from the deduction. [*Dobson:* “No principle of law compels the Tax Court to find taxable income in a transaction where as a matter of fact it found no economic gain.”] Don’t apply TBR if previous deduction was harmless.

      §111(a): Codification of exclusionary side of TBR. Gross income does not include income attributable to recovery such that the amount did not reduce taxable income in the previous year.

   c) **Tax Benefit Rule Not Applicable to S&B:** Even though S&B never got a benefit from the original deduction, the TBR does not apply to S&B: limited to recovery of money from the people it was originally paid out to. S&B can only resort to §172.

   d) §111(TBR Exclusion) & §172 (Carryover Deduction): Money received (S&B) or recovered (Dobson) creates injustice – if rates go up in later year, TP pays more, deduction means less. But if rates go down in later year, Treasury hurt because deduction means even more. Unless error in return, §441 applies. No error in Dobson or S&B. §172 is so broad now, it generally applies to anything TBR would.

7) **Health Care Costs for “Medical Care”:** There are three ways to finance the cost of health care, with three different tax treatments:

   §213(d): Definition of Medical Care: Medical Care is care for…diagnosis, cure,
mitigation, prevention of disease…etc.

a) ER-Provided Coverage: ER-provided coverage includes participation in group health insurance plans. From perspective of the EE, health care provided by the ER is tax-free, and with many policy ramifications: 1) Incentive for EE to enroll in ER-sponsored health plan. Both payment by ER and receipt by EE are tax-free. Congress is encouraging EE participation so nation is widely covered, example, unions bargaining to induce broad coverage. Ted Kennedy: this is national health insurance. Also, on health care side, insurance companies can better bargain to control costs.

Also, Exclusion of payment by ER and exclusion of receipt by EE may lead towards 2) Inflation of health care costs. EEs don’t pay insurance directly so demand increases when it may not be require. Also, because EEs don’t pay directly, attention to healthy diet, smoking, exercise not as highly regarded. Republicans: cap catastrophic health insurance.

Additionally, 3) Encourages Self-Insureds to not buy health insurance because 7.5% floor on deduction means unless income spent on HI is more than 7.5% annually and thus deductible, just save money and spend it on health problem when it arises, thus getting the big deduction then.

Premiums: Excluded
§106: Contributions by the ER to accident and health plans are excluded from gross income.

Proceeds: Excluded
§105(a): All amounts received by EE but paid by ER shall be included in gross income.
§105(b): Despite what 105(a) says, proceeds for medical care are excluded from gross income.

b) EE-Purchased Coverage: EE-purchased coverage includes health care coverage purchased directly by EE.

Premiums: Limited Deduction
§213(d)(1)(D): Amount paid as premiums covering medical care are deductible. But such a deduction has significant limitations: a) all medical expenses must exceed 7.5% of AGI (thus $7500 for someone making $100K a year; b) the deduction is an itemized deduction and thus must exceed the standard deduction.

[Ochs v. Commissioner: TP’s wife is very ill with cancer, doctor orders that children be sent to boarding school so they won’t aggravate mother while she recovers. Father with annual income of $6K sends kids to school, claims cost of school, $1,456.50 is deductible as §213 medical expense. Held: Such an expense is not a §213 deductible medical expense. Congress did not intend to transform family expenses into medical expenses.]

Proceeds: Excluded
§104(a)(3): Gross income does not include amounts received through health insurance

c) EE Self-Insurance: Self-Insureds pay medical expenses directly have no insurance.

Premiums: NA: (Self-Insured Has No Official Insurance Plan)
Proceeds: Limited Deduction
§213(a): As with EE-purchased coverage, upon receipt of “proceeds” deductible if more than 7.5% of HI

8) Health Care Costs Not For Medical Care: For health care costs not considered medical care by §213(d), there is different tax treatment. These costs are, for example, cosmetic surgery and even sickpay coverage and disability insurance. Either way, there is a tax somewhere on the
transaction. Incentive to participate in ER coverage because premiums excluded, unlike for EE-provided where premiums are not deductible.

a) ER-Provided Coverage:
   **Premiums:** Excluded
   §106: As with health care plans, premiums for non-medical coverage are excludable.
   **Proceeds:** Included, w/Possible Credit
   §105(a); §22: Unlike the medical care which is excludable per §105(b), non-medical care is included but there may be a credit per §22.

b) EE-Purchased Coverage:
   **Premiums:** Not Deductible
   §213(d)(1)(D): Such payments not within definition.
   **Proceeds:** Excluded
   §104(a)(3): Excluded because such payment are not 213(d)(1)(D) excludable.

c) EE Self-Insurance:
   **Premiums:** NA: (Self-Insured Has No Official Insurance Plan)
   **Proceeds:** No Deduction
   §213(d)(1)(D): No Deduction because payments are for insurance expenses that are not medical.

VI. THE TIMING OF INCOME

A. Annuities: Annuities are investments of limited duration – they are a sequence of equal payments to the annuitant purchased by the annuitant for a principal. The demand for these Ks is so that people do not outlive their savings. The payment by the annuitant is the principal and can be one premium or several premiums. The cost of the principal depends upon the annuitant’s life expectancy. The insurance company holds onto the payments and earns interest on them. The payments by the insurance company are equal periodic cash payments to the annuitant. Thus tax treatment of annuities is concerned with which is income and which is return of capital.

1) Different Methods of Possible Treatment: There are several alternatives for deciding which receipts are taxable income and which receipts are tax-free return of invested capital.

   i) Return of Capital First: Return of Capital first means the annuitant gets back the tax-free cost of the principal first and is then taxed on the payments after the ROC. Thus IRS gets money last. This is the Pre-1934 method.

   ii) Return of Capital Last: Return of Capital last means the annuitant is taxed on the value of the payments received first, thus IRS gets money first, and then annuitant gets back the cost of the principal. This is §1001, essentially, taxing enrichment.

   iii) Pro-Rata Return of Capital: A pro-rata ROC means TP is not taxed on the percentage of the payments that represent the principal, thus: Principal Price of $3790/Annuity Value of $5000). So only the percentage of income above the ratio is taxable income. This is like Straight-Line depreciation.

   iv) Back-Load ROC: Back-load ROC means essentially TP is the creditor giving a mortgage loan of say, $3790, to the insurance company. As the insurance company pays back the loan of $1000 annually for 5 years, with 10 compound interest, 10% of the original loan would be $379 of the $1000. The remaining $621 is return of principal. In the second year, as the insurance company has paid back $621, they now owe back $3169 of the principal. So of the $1000 paid in year 2, 10% of $3169 is $317 so the $317 is interest and taxable to TP while $683 is tax-free ROC to TP. In year 3, $1000 paid, with
$2486 of the principal needed to be paid, $249 is taxable interest with $751 tax-free ROC principal. Etc.

v) **Front-Load ROC**: The front-load ROC is like say, 5 separate endowment contracts, in which TP gets back the money already put in.

2) **History**: Of all the methods, Congress essentially settled on the Pro-Rata ROC.

   **Pre-1934**: Before 1934, the annuitant was not taxed until all of the principal had been returned.
   **1934-1954**: The rule from 1934 to 1954 was that the annuitant receiving annual payments had to report as gross income 3% of the total principal for the annuity contract, with the balance of the payments considered excludable. Problems however, were that many annuitants would have to live for a long time before gaining the return of capital.
   **1954-Present**: Congress changed annuity treatment in 1954, §72(b)(1): The Exclusion Ratio: The Exclusion Ratio is like the Pro-Rata ROC: TP gets back annually as tax-free proportion of capital already Exclusion Ratio = Investment in K/Expected Return. So to calculate, multiply annual payment X Exclusion Ratio. Thus, exclusion ratio is the percentage of income TP gets tax-free.
   §72(c)(1): Definition of Investment in K: Amount paid for the K, etc.
   §72(c)(3): Definition of Expected Return: Aggregate of amounts received, etc.

1986 Amendments:
   §72(b)(2),(3),(4): Mortality Gains and Losses: in 1986 Congress amended §72 to recognize the impact of death before the end of the K and death after the end of the K. An annuitant who dies prematurely can deduct the unrecovered cost from the final tax return. While an annuitant who survives the mortality date must include all of the subsequent payments as income.

B. **Life Insurance Contracts**: Life insurance is bought to secure income for the beneficiary in case of early death of the breadwinner/insured.

1) **Term Life Insurance (Endowment Insurance)**: Term life insurance is insurance that insures against death during a specified limited period, like 1 or 5 years. Terms are fixed, no payout if death after end of term. It represents effectively pure insurance.

2) **Whole Life Insurance**: Whole life insurance is insurance that provides payable benefits upon death of the insured, regardless of the when the death occurs. It represents much investment and savings. The amount of “pure insurance” the recipient has goes down as insurance payments go up. Recipient is gaining money it hasn’t put in.

**Premiums**: Non-Deductible
§265: Premiums spent for life insurance are considered non-deductible.

**Proceeds**: Excluded
§101(a)(1): Proceeds received by life insurance are excludable “mortality gains” are excludable. There must be death. Some TPs surrender for cash value, process them through §72(e)(1).
§101(c): Interest on policy paid over time by insurance company after death is not excluded.
§101(d): Life insurance proceeds over time is essentially annuity payments, ratio required (response to AIDS crisis, people needed money then).

**Policy Effect of Treatment for Life Insurance:** Much lobbying by insurance industry for §101(a) results in: a) **Violation of Economic Neutrality:** TPs will be more likely to put money in life insurance than in other forms of savings because payment of life insurance to family is tax-free and just a small purchase of contract may net a huge reward if he dies early; b) **Horizontal Inequity:** TPs in same situations will be taxed differently – TP1 who invests in stocks, etc. taxed on gaing vs. TP2 who “invests” in life insurance not taxed on gain.

3) **Sale of Life Insurance Contract:** Sale of a life insurance contract, assume insured is owner.

   §101(a)(2): Upon sale, transferee/buyer can exclude his basis from gross income when proceeds pay out.

   **BUT IF**

   §101(a)(2)(A), (B): If transferee’s basis determined by transferor’s basis, transferee can exclude proceeds or if §101(a)(2)(B): transferee is insured, or in partnership, corporation, etc. with insured.

   Treas.Reg. §1.101-1: Illustrations.

C. **Realization and Recognition:** The **Realization Requirement:** Realization is an administrative rule, not a constitutional rule nor an economic rule. The tax system does not extend to taxing changes in the value of property, marketable property (ex., securities) unless realization requirement. The significance of the realization requirement is certainly timing: tax can be deferred by failing to trigger realization.

1) **Questions of Realization:** Realization means gains derived. Macomber establishes that realization of gain is a precondition to taxation. [Eisner v. Macomber 252 U.S. 189 (1920): TP owned 2200 shares of Standard Oil, received 1000 shares of stock from Standard Oil, worth about $20,000. TP claimed stock dividend was not within the scope of gross income. Taxing dividends was a) Unconstitutional because dividends are not within the meaning of the 16th Amendment. Pitney Held: Major Premise: There was no realization, “[W]hile indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.” Income means gain DERIVED FROM CAPITAL, there was no gain from the capital.

   Minor Premise: TP got nothing from the corporation anyway, Standard Oil kept all the profits. Not even change in ownership, all SHs got was increase in shares.

   Options for Corporation with Profits:
   1) Retain, Invest & Expand Business
   2) Retain, Invest & Issue Stock Dividend
   3) Issue Optional Stock or Cash Dividend
   4) Distribute as Cash Dividend

   Pitney: No difference between 1 & 2 because ownership does not change, like in Macomber. 1 & 2 very similar, Congress cannot tax 1 and thus cannot tax 2.

   **BUT**

   Brandeis Dissent: There was realization, the customers gave money to Standard Oil, who bought its own stock, then gave it to shareholder Macomber. What happened here was 2 which is the same as 3, which is unquestionably taxable. Regardless, Congress has the power to draw line.

2) **Macomber Implications:** Realization concerns questions of timing. Regardless, Congress has power to tax shareholder Macomber, though SH got something, the question is when is it taxable.

   i) **Tax Deferral, Not Tax Forgiveness:** SH Macomber will be taxed, the question is just when. If value goes up and SH sells, then §1001(a) applies (Amount Realized – Basis).

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ii) *Mere Appreciation in Market Value is Not Taxable*: Increase in value is not income. [*Macomber: Held Pitney*: “[E]nrichment through increase in capital investment is not income in any proper meaning of the term.”]

iii) *Business Income Tax Alternatives*: The US is one of few countries that continues this system, it leads to mischaracterization of profits and scrambled transaction problem.

§11: **Classical Corporate Tax System**: A classical corporate tax system treats the corporation as a separate entity on corporate profits earned.

AND

§61(a)(7): **Tax on Shareholder**: Dividends are gross income.

... *Thus Double Tax* on Corporate Profit and SH distribution, leading to a disincentive to distribute.

VS.

§701: **Partnership Taxation**: Partnership taxation of LLPs, LLCs etc., not taxed like a corporation, they “pass-through” business taxation.

3) **Policy Rationale of Realization Doctrine**: The realization doctrine has several profound policy implications.

a) **Administrative Practicality**: With change in FMV, an appraiser does not need to always check on the change in value, furthermore, if an appraiser were to check on the change in value of property (securities, real estate), TP appraiser and IRS appraiser would always disagree.

4) **Policy Problems with Realization Doctrine**: On the other hand, despite administrative concerns, a) **Vertical Inequality**: Some TPs – the very wealthy – will hold onto their property and retain their savings rather than realizing gain. The wealthy will not pay as much. [*Macomber: Brandeis Dissent*: [T]he owners of the most successful businesses in America will, as the facts in this case illustrate, be able to escape taxation on a large part of what is actually their income.”]

5) **Congressional Responses to Realization Doctrine**: Congress a) codified Macomber in §1001(a) in definition of gain. And Congress b) basically created exceptions and complications for taxability of stock dividends.

§305(a): Gross income does not include distribution of common stock.

§307: Basis of dividend shares is proportionate to stock held originally. Divide basis of original stock by amount of new stock to get new basis.

6) **Reinterpretation of Macomber: Timing Rules**: Proper timing of realization occurs not just in receipt of cash, but upon taking control, possession, etc. [*Helvering v. Bruun* 309 U.S. 461 (1940): In 1915: TP acquires land for 99 years; leases to tenant; 1929: tenant demolishes building and builds new building to last for approximately 50 years, value of new building was $64K, old building $13K, thus amount realized = $51K; 1933: Landlord defaults on K (Great Depression), TP repossesses land from tenant. TP: No realization because there isn’t gain from capital [Macomber] IRS: Gain of $51K realized in 1933. *Held*: “IRS was right in assessing gain as realized.” *Gain may occur* as a result of exchange of property, payment of the TP’s indebtedness, relief from a liability, or other profit realized from the completion of a transaction.” Transaction was taking back the land, building need not be sevarable.]

   a) **Lessee Improvements**: There are four means of taxing the transaction of lessee improvements, first 3 are all questions of timing.

   i) **Post-Paid Rent**: Post-Paid Rent is the realization, and thus taxation of improvements upon the expiration of the lease. Landlord has income at end of lease, income is FMV of improvement. Basis for computing depreciation would be the FMV.
ii) **Pre-Paid Rent**: Landlord has income on year improvement is made, income is equal to predicted FMV of building at end of lease, discount to present value.

iii) **Pro-Rata Rent**: Spread out the predicted FMV on lease termination over the course of the lease.

iv) **No Rent**: Landlord has no income at all from lease transaction.

b) **Taxation of Transaction**: Supreme Court says tax *Bruun*. Landlord in 1933 on value of gain from new building. For a landlord like the one in *Bruun*, landlord could be:

1) Taxed in 1933: Rent is §61(a)(5) income. Income = GI – Depreciation Deduction (Adj. Basis/Period of Use). Then he can lease the land again for higher rent now that he has a nicer building and he will get some return of capital. The basis goes up as property is included in income. Proceeds go up, thus basis goes up. Tax deferral. Thus, *Bruun* is a Tax on Transaction.

   **BUT**

2) If Not Taxed in 1933: If landlord is not taxed, then there is no depreciation deduction, and if no depreciation deduction, no change in basis. So when the landlord sells the land with the new building on it, he’s taxed on all of the gain. Tax deferral also, but he’ll just pay more when he sells it.

7) **Congressional Response to Taxation of Transaction**: Favorable Timing Rule: Congress agrees a) they have the Constitutional power to tax the transaction but declines to do so because b) legislative grace. These transactions were occurring in the midst of the Great Depression and though *Bruun* landlord just made $51K, he likely doesn’t have the cash to pay the tax.

§109: Exclusion Provision: Congress declines to tax improvements on the lessor’s land by the lessee. Thus, improvements are not income on transaction and thus not taxable. TP “gets” $51K and is not taxed on it.

   **BUT**

§1019: Congress also says that the lessee will not get a basis for the improvements made by the lessee. Upon future sale, TP will have to pay tax on amount realized, cannot deduct depreciation of building during ensuing period. *Thus Tax Deferral*...Congress will get the money eventually. TD is interest free loan from Gov. Benefit: get taxed at lower income when retired, no high salary. Not good for people going into higher incomes.

8) **Computation of Realization and Recognition**:

§1001(a): **Gain (Loss)**: [Amount Realized: §1001(b): The Amount Realized is the sale proceeds (amount of money owed to TP) + the FMV of the property (FMV of like-kind property).

**Recognized**: §1001(c): Entire amount shall be recognized, unless otherwise…

§1031(a)(1): Congress will not tax realized gain if it chooses not to. However, TP must satisfy all to earn the prize of non-recognition. Congress will not recognize a gain if it’s an 1) exchanged & 2) trade or business or investment & 3) solely for 4) like kind property 5) to be held for trade or business or investment. This is non-recognition of like-kind exchange only.

§1031(a)(2): Exchanges don’t apply to certain exchanges, stock in trade means inventory.

- [Adjusted Basis]: §1011: Adjusted Basis is §1012 cost of property +/- Adjustments (+ for improvements; – depreciation deductions).

§1031(d): **Basis of Exchanges**: Upon exchange of §1031 “like kind” property (or §1035(a) insurance policy or §1036(a) also apply) transferee’s New Basis/Total Basis Prop. Rec’d = Basis Prop.Given – $Rec’d + GainRecog’ed – LossRecog’ed Recognized Loss on Lifetime Exchange when you use boot to buy.

§1031(b): **Boot**: If some “other property” which is not like kind or some money is exchanged along with the property, then the boot is recognized gain.

= §61(a)(3): **Gains** derived from dealings in property
9) **Exchanges**: “Even Exchange Hypothesis”: For non-related parties, assume value given is the same value as that received.

a) **Definition of “Like Kind”**: Congress provides no definition of “like kind” but underlying the whole theory of non-recognition is that formal similarity does not matter, instead what matters is nature and risk, etc.
   1) Real Estate for Real Estate is *Always* like kind;
   2) Real Estate for Personal Property is *Never* Like Kind;
   3) Personality for Personality is Like Kind if:
      a) **Intangible Personal Property**: To be like kind, consider Nature and Risks of Investment
      b) **Tangible Personal Property**: Treas.Reg. §1031(a)-2: To be like kind: 1) same depreciation class OR 2) same product class.

Recognition of boot: TP will be taxed up to the boot because TP is bailing on original property. [Alderson: Like Kind for Like Kind not recognized.]

b) **Non-Recognition of Loss**: In addition to not recognizing a gain in an exchange, §1031 also does not recognize a loss on exchange. These losses on exchange are not §165 deductible losses. So if TP want to have loss recognized, then sell land and then take loss deduction, don’t sell TP has control.

c) **Manufactured Exchanges**: §1031(a)(3): prevents TPs from manufacturing exchanges of deeds to avoid paying tax on gains. Requirement of 180 days.

d) **Policy Rationale for §1031 Tax Deferral on Exchanges**: 1) Administrative Convenience so as to lead to the avoidance of valuation controversies. Property received on exchange might not have a FMV so Congress says wait until it has value from sale, then tax it; 2) **Taxpayer Compliance: Liquidity Concern**: TP may not have the available cash to pay for the gain on the new property, if realized gain were recognized then TP would have to sell the property to pay the tax. So Congress says wait until sale and then tax because then there’ll be a cash flow and money to tax; 3) **Horizontal Equity**: in that TP exchanges land for like land, basically has same land, TP shouldn’t be taxed for swapping for economic equivalent.

e) **Policy Problems with §1031 Tax Deferral on Exchanges**: The biggest problem with §1031 is the **Violation of Economic Neutrality: Capital Lock-In**: As Economic neutrality concerns are always raised with Horizontal Equity concerns, TP may have money in land appreciating at 9% and want to invest in securities appreciating at 11%, for example, but would be discouraged because exchange would lead to realization event and recognized gain on which TP would be taxed. Thus TP is deterred from making a decision that would lead to a better allocation of wealth.

f) **Policy Rationale for §1031(a)(2) Exception to Non-Recognition**: Congress refused to except exchanges of stock, etc. from recognition because a) Administrative Practicality: Congress would be granting needless tax-deferral in such situations, b) **Vertical Inequity**: The wealthier could just exchange stock, etc. infinitely, stocks would thus always be exempt; c) **Theoretically**: Exchange of stock not necessarily like kind for exchanged stock of another company. Even livestock of different sexes, §1031(e).

10) **Involuntary Conversions**: TP’s gain is not recognized if the gain was not elective to begin with. If the TP gets proceeds to replace the lost property within two years with other property that is similar or related in service or use, realization not recognized. Replacement must be timely, gain will be recognized if not done because property lost, etc. Property does not need to be like the property in §1031, standard is functional equivalence. **Horizontal Equity**: When TPs get
gains, they should be taxed if they don’t stick with original investment. Loss on involuntary conversions is always recognized.

§1033: If you’re forced out of your property and invest proceeds into something similar, you will not be taxed on those proceeds. But if you take those proceeds and bail out of your original investment, you will be taxed.

§1033(a)(1): Money must put “into property similar or related in service or use.”

OR

§1033(a)(2)(B): “Purchases other property similar or related in service…”

Amt Realized on Conversion (Replacement Proceeds)

— Replacement Proceeds Spent on Similar Replacement

Recognized Gain

11) Exclusion of Gain from Sale of Principal Residence: Gross Income does not include the income received based upon the sale of TP’s principal residence. Congress could tax this gain but it doesn’t. This is tax forgiveness, clearly. Limitations though, are that residence must have been principal residence 2 of past 5 years, limitations on value excluded, etc..

§121: You’re not taxed on enrichment from sale of house. Historically, though, tax deferral and basis transferred, etc. Unrecognized gains would build up, older TP’s impacted that huge tax at end. AARP pissed. Also, seniors had Capital (Housing) Lock-In: they wouldn’t sell house when they went to retirement home, then kids inherit house tax-free.

a) Rationale for Exclusion: Major rationale: a) Political Interest to get votes from middle class; b) Ends Labor Lock-In: People will sell house to take better job elsewhere.

12) Realization of a Loss: Realization of gain, or loss, depends upon exchange of properties materially different. [Cottage Savings: 499 U.S. 554 (1991): TP Mortgage portfolio exchanged for another mortgage portfolio. TP wanted realization because TP could then record a loss. TP: There’s been a realization event and we should be able to record §165 loss. Form over substance. IRS: Not a realization event because portfolios not “materially different,” economic substance has not changed, thus TP cannot record the loss. Substance over form. Held: Realization is determined by “material difference”; this was a realization event. Even though properties were economic substitutes, there was an exchange between unrelated parties at arm’s length. For Administrative Convenience, IRS should recognize realization event. They can find event and tax it. Materially different means “possessors enjoy legal entitlements that are different in kind or extent.”]

13) Losses with Respect to Transactions Between Related TPs: We only tax gains beyond the losses that Family Member #1 could not get recognized. FM#2’s wholly owned corporation is considered constructively owned by FM#1. But in-laws not FMs.

§165(a): Losses are deductible.

BUT

§267(a)(1): TP not allowed to deduct the losses on the sale of stock if it’s to someone related. Deduction disallowed if sale is direct or indirect (through NYSE). Thus no “straw men” will allow FM#1 deduction. [McWilliams v. Commissioner: Held: No straw men allowed.]

§1012: Family members #2’s basis in stock is purchase price from family member #1.

BUT

§267(d): Family member #2 sells the stock for gain, then;

Recognized Gain = Overall Gain – Family Member #1’s Unrecognized Loss
14) **Wash Sales**: If TP sells stock and records §165(a) loss, TP can’t go out and then buy more stock. You must be out of the market long enough.

§1091: If TP sells within certain amount of time, no deduction allowed if TP goes and buys more of the same.

§1091(d): Basis in the new shares:

\[
\text{Basis New} = \text{Basis Old} + (\text{Price New} - \text{FMV Old})
\]

\[
\downarrow
\]

\[
\text{Basis New} = \text{Price New} + (\text{Basis Old} - \text{FMV Old})
\]

\[
\downarrow
\]

\[
\text{Basis New} = \text{New Cost} + \text{Disallowed Loss}
\]

D. Loans and Offsetting Claims:

1) **Loans Are Not Income**: TP receives loan, loan is not income because debt to repay offsets the gain. Upon repayment principal payments not deductible, because no net disenrichment

§163: Interest payments to repay loan are deductible.

2) **Discharge of Indebtedness**: When debt is cancelled (or portion thereof) debt or debt portion is income. [United States v. Kirby Lumber Co.: 284 U.S. (1931): TP issued some bonds and then bought those bonds back for $137K less than what issued. Held: TP now did not have to pay back $137K for the bonds, income was freed up, that is gross income.] However

Not all discharge indebtedness is income. Discharge not income is nothing was received tax free.

   a) **Insolvency Exception**: Exception to the rule that discharge of indebtedness is income.

   §108: Income from cancellation of indebtedness is excluded from TP’s income if TP is insolvent or cancellation occurs because of a bankruptcy proceeding. Does not apply to companies that buy back their debt. Such cancellation of their debt is income. TP must be insolvent before cancellation of indebtedness and after cancellation of indebtedness.

   Insolvent:

   \[
   \text{Liabilities} > \text{Assets}
   \]

   i) **Enrichment Rationale of KL & Insolvency Exception**: Looking at big picture, wealth has increased for TP [Kirby Lumber], some assets have been freed from the claims of all total creditors. If debtor insolvent, though, there has been no increase in wealth. If debtor is insolvent though, was enriched but now won’t be paying. So Recapture Rationale…

   ii) **Recapture Rationale of KL & Insolvency Exception**: The recapture rule is that the prior loan treatment was erroneous so IRS now needs to tax. If you got $1K in past and then that debt was forgiven, now you’re gonna get taxed. Like the inclusionary side of TBR. Recapture rationale of KL disregards Insolvency Exception and seeks to go after income regardless, that’s why §108 was created.

   §108(a)(1): Gross income will not include amount of debt cancelled if discharge of debt occurs when TP is insolvent.

   §108(a)(3): The amount of income excluded because of TP’s insolvency exception can only be to the extent of TP’s insolvency.

   ALSO

   §108(b)(1): Though TP gets an exclusion, this is only **Deferral**, there’s a NOL reduction, basis reduction, etc. Much like §109 and §1019. TP will get taxed eventually.
b) Debt Must be Legally Enforceable and Not Purchase Price Adjustment: In order to incur §108, the debt must be legally enforceable, not a debt if PPA. [David Zarin: TP was big gambler, given $3.4M from Casino to gamble, doesn’t pay it back, Casino sues for the $3.4M, TP pays $500K as settlement. IRS: $2.9M is taxable income from §61(a)(12) discharge of indebtedness, Kirby Lumber and TP can’t use §108 insolvency exception because he’s not bankrupt or insolvent. TP: a) Debt to casino not §108(d)(1) legally enforceable debt, b) it was a purchase price adjustment. Nonetheless, TP would not be able to §165(d) deduct losses because they were not the same year. NOL only applies business. Tax Court Held: $2.9M is income because it was a legit loan from the Casino otherwise, $3.4M should have been taxed when it was given to him, TP acted like a borrower. Tax Court Dissent: This was not income but was losses and now TP’s taxed on losses. 3rd Circuit Held: There was no agreed upon indebtedness, this was contested and not necessarily income. It was just a settlement of $500K. 3rd Circuit Dissent: $2.9M was income to him.]

3) Claim of Right: Though borrowed money is not income, if TP receives money under a claim of right it is income. If there are contested issues as to the money, and the money must be given back in future, then loss can be deducted then. [North American Oil Consolidated v. Burnet: 286 U.S. 417 (1932): In 1916: Oil Royalties were collected by receiver because ownership in dispute; 1917: Court ordered Royalties handed over to TP; 1922: Royalties officially those of TP. TP: Tax on in 1916 when receiver got $ or 1922 when royalties officially those of TP. IRS: Tax in 1917 because that’s when TP got $. Held: Tax in 1917 because that’s when TP held under “Claim of Right.”

i) Two Methods of Accounting: The Court applies TP’s method of accounting, TP cannot choose.

1. The Cash Method: The Cash Method of Accounting is that the year of receipt – actual or constructive – is the year of inclusion. [North American: No constructive receipt in 1916, otherwise to have constructive receipt you must be able to get it on demand.] This is the general method of accounting for TPs who do not keep books, simpler method, when $ actually or constructively comes.

2. The Accrual Method: The Accrual Method is the method by which TP doesn’t include as income until all events necessary for receipt has occurred. The right had been fixed and or the obligation to pay has matured.

ii) Rationale for Claim of Right Doctrine: The Rationale for the Doctrine is Administrative Practicality: It’s easier to tax money now than to wait until all the dust has settled. Furthermore, people would not pay tax because they would say there’s a “dark cloud” over their income and they may need to pay it all back.

iii) Problems of Claim of Right Doctrine: [United States v. Lewis: 340 U.S. 590 (1951): In 1944: TP got bonus in $11,000, reported as income; 1946: TP gives back bonus because it has been computed improperly and gets a deduction. Held: Bonus taxable in 1944. However, rate change b/w 1944 and 1946, rate had been higher in 1944. Thus he would have paid more in tax in 1944 than he would be able to deduct in 1946.

iv) Congressional Response to Problems of Claim of Right Doctrine: Because an intervening rate change would mean that the TP might have paid more than he’ll be able to deduct, Congress responded to Lewis.

§1341(a): If an item is included in income one year because a claim of right and then paid back and deducted later, if the deduction is more than $3K, TP’s tax: Later Year Tax = Lesser of: (Later Year Tax w/Ded.) OR (Later Year Tax no/Ded. – Amount that would not have been taxed if item had not been received earlier)
5) **Embezzled Funds**: Stolen money is fully taxable in the year the money is obtained. [James v. United States: 366 U.S. 213 (1961): Union official stole funds, $738K. TP: Embezzled funds excluded from income because they’ll be paid back, much like a loan. Relying on [Wilcox] IRS: Funds were taken by claim of right, they’re definitely income. Held: Embezzled funds treated like claim of right income, when you pay it back, you’ll get deduction. However, it’s not too likely that TP will ever repay…][McKinney v. United States: 574 F.2d 1240 (1978): In 1966 TP embezzled funds from ER, paid taxes on income as “miscellaneous income.” 1969: embezzlement discovered, he pays back and TP: wants treatment §172 NOL deduction OR §1341. IRS: TP gets §165(c)(2) deduction not related to business but entered into for profit. Held: No §172 because not trade or business NOL because embezzlement not job; §1341 does not apply to him either, they were not held under a claim of right of §1341 not broad enough to include embezzled funds within claim of right.]

   i) **Rationale for Realization of Embezzled Funds**: Embezzled funds treated as income because a) Facts require it. Too difficult to treat as loan, finding embezzled money and then giving embezzled money back both very unlikely.

4) **Non-Recourse Borrowing**:

A **recourse loan** is a loan for which the TP borrower is personally responsible for any deficiency in the collateral value – borrower is personally liable for repayment. When TP does not payback, lender’s recourse is to go after TP’s personal liability.

A **non-recourse loan** is one in which the borrower is not personally responsible for repayment. It is a loan without recourse against the personal liability of the borrower. The lender’s only remedy is to take away TP’s collateral – lender is without recourse to go after personal liability of debtor.

   **Amount Realized**: Amount realized includes cash from buyer and the assumption of the balance of the mortgage. [Crane v. Commissioner: 331 U.S. 1 (1947): Held: Mortgage should be included in amount realized and basis.] [Commissioner v. Tufts: 463 U.S. 1215 (1983): TP’s collateral property worth less than balance of mortgage. Held: TP’s realized balance of mortgage, regardless of property’s FMV. O’Connor Concurring: Real way to evaluate case was to unscramble into scrambled transactions: 1) sale (no realized gain so capital loss) and then 2) use of sale proceeds to pay off debt (unpaid debt is income from cancellation of indebtedness so ordinary income). NR loan shouldn’t be income tax when forgiven.]

   §7701(g), Treas. Reg. §1001-2(a)(1), 2(a)(4)(i), 2(b): Congress incorrectly codifies Tufts: On disposition of property subject to nonrecourse liability, NR liability is amount realized. (Wrong Rule)

   & to Treas.Reg. §2(a)(4)(ii): For disposition of property subject to recourse liability, amount realized is amount of liability if purchaser agrees to pay liability. (Right Rule)

   **Adjusted Basis**: Adjusted basis includes cost paid for property plus mortgage. [Parker v. Delaney: 341 U.S. 926 (1951): TP deducted depreciations allowance, that portion subtracted from costs.]

**Gain**

VII. THE PROPER TAXPAYER (PROGRESSION PROBLEMS)

A. Gifts and Kindred Items:

   Is TP enriched:  Donee: **Yes**: §61(a) Enrichment --

   Donor: **No**: Disenrichment, giving away after-tax savings.
Enrichment is:

\[ Y = *C (\$262) + \Delta W (\$263) \]

(Income = Consumption + Change in Wealth)

* … Core of Tax Base, Neither of these is deductible. Period.

§102(a): Exclusion for Donee: It’s enrichment but that doesn’t mean it will be taxed.
§170(c): Deduction for Donor for Charitable gifts ONLY.

1) **Policy Rationale for Tax Donor, Not Donee**: IRS concerned with material consumption, intangible consumption to the donor too hard to tax. The reasons we essentially tax donor but not donee is a) **Administrative Practicality**: 1) If we taxed the donee and not the donor, then wealthier parents could give car to children in lower tax bracket but drive children’s car. IRS would have to investigate all gifts to see if disguised consumption; also, 2) Donor and donee might always report when giving gifts. This would be a tax on honesty and would engender disrespect for tax system].

2) **Divided Interests in a Gift**: Income from a gift in the form of interest, dividends is includable in gross income. [Irwin v. Gavit: TP and daughter both inherited gift from decedent, interest to TP and remainder to TP’s daughter. Interest to father, the income beneficiary, over the years was includable as gross income. However, corpus to daughter, principal beneficiary, is excludable].

§102(b)(1),(2): Income from gift is not excludable.

a) **Sale of Income Interest**: Buyer Reports: Sale of income interest, like Gavit’s, requires the buyer to use exclusion ratio, essentially treating income as an annuity.

b) **Sale of Income Interest: Beneficiary Reports No Dep. Or Amortizations**: §273: Income beneficiary cannot make depreciation deductions or amortization. [Commissioner v. Early: TP allegedly receives inter vivos gift, TP: §167 should apply, “gift” was purchased and so TP can make depreciation deductions. IRS: Not a purchase but a §273 life interest gift and so TP cannot make depreciation deductions, no amortizations, etc. Held: It was not purchased but a gift, no amortization deductions, etc.]

§1015(e): Income beneficiary’s basis disregarded. So Income beneficiary’s adjusted basis is 0, Gavit pays on everything.

c) **Sale by Principal Beneficiary**: Principal Beneficiary Reports:

Amount Realized:
– Adjusted Basis: The Principal Beneficiary’s adjusted basis is amortized til maturity, that way donee will get full basis at taking of gift.
§1015: Donee Takes Donor’s basis in a gift.
§1014: If death, donee takes basis of FMV of bequest.

d) **When Both Sell Gift**: When both sell gift,

§1001(e): Buyer gets corpus immediately, F&D divide up shares.

3) **Basis of Property Acquired by Gift**: §1015(a): Upon **Gain**: On donative transfer, donee acquires donor’s basis when gift’s FMV appreciates. This is so a tax is collected somewhere, typically transfers are made to younger people, avoids outright tax forgiveness. [Taft v. Bowers]

\[ BUT \]

Upon **Loss**: Donnee’s basis: lesser of: donor’s basis or FMV at transfer
4) **Basis of Property Acquired by Death:**

§1014: Property acquired by decedent has basis of FMV @ decedent’s death. “Stepped up Basis Rule.” So if FMV goes up, that much $ is forgiven.

i) **Policy Problems with §1014:** 1) Exacerbates Capital Lock-In: TP won’t sell farm so that he won’t be taxed on it. **BUT** 2) If No Capital Lock-In, Liquidity Concern, when kids inherit farm, because it’s realized gain, they would have to sell farm to pay tax. Both ways are bad.

B. **Prizes and Awards:**

§74: **Prizes and Awards:** Inclusive Provision: Almost all prizes and awards are includable, except those which are given for 1) recognition of religious, charitable, scientific, etc.; 2) recipient did not take action to enter proceeding and no future service required and gift is assigned elsewhere to charitable organization, etc.

§117: **Scholarship and Fellowship Grants:** Excludable.

C. **Business Gifts:** “Mixed Motive Gifts:” There can be gifts in a business, for example, legal partners exchanging Christmas gifts. [Commissioner v. Duberstein: (1960): Cadillac to business associate; Held: Test to determine if excludable business gift is test is to be done by fact-finder, however there can be no specific definition or bright-line Rule. Motivation here was business] [Stanton: (1960): $20K to retiring minister a gift b/c of good will, etc. a gift if fact-finder thinks so] [Kaiser: (1960): strike benefits are a gift, in kind, etc.]

1) **Congressional Response:** §274(b): No deduction by a business for gifts, thus IRS no longer “whipsawed” on both ends. Thus no such thing as a deductible gift. §102(c): No ER-EE gifts, either.

C. **Marriage and Divorce:**

1) **Property Settlements:** No deduction for transferor. [Farid-Es-Sultaneh v. Commissioner: (1947): Wife’s basis in stock exchanged for divorce is FMV of stock at transfer.] [U.S. v. Davis: (1962): Husband realizes gain on transfer of property to wife for divorce.]

§1041(a): Transfers between divorcing couples are treated as a gift, no realization or recognition. §1041(b)(2): Basis transfers, regardless.

2) **Alimony:**

§71: Gross income specifically included in alimony payments to “recipient spouse.”

§215: Deduction to “payor spouse” for alimony payments.

i) **Alimony Recapture Rule:**

§71(f):

3) **Child Support:** No deduction for the payor, no inclusion for the payee.

**VIII. COSTS OF PRODUCING INCOME (DEDUCTIONS)**

A. **Business and Investment Expenses:**

1) **Ordinary**: An ordinary expense must be common or typical in the business world, otherwise the TP might be new and spend on things like orgies.

2) **Necessary**: An necessary expense must be “Appropriate and Helpful;” otherwise courts would second-guess every expenditure. Free market economy.

3) **Public Policy Disallowance**: Some deductions are disallowed if they frustrate public policy.
   - §162(f): No deduction for any fine.
   - §162(c): No deduction for bribes or kickbacks.
   - §162(e): No deduction for lobbying, etc.
   [Tellier: Legal expenses are deductible in defending business.][Mazzei: deduction for theft would encourage theft.]

   §263(a): Capital Expenditures Not Deductible: [Mt. Morris: Held: Drive –in theater cannot deduct drainage system because that would be capital expenditure. Dissent: it was a business expense, deduct now.]

**B. Educational Costs**: Educational costs are rarely deductible, even though deductibility would make good sense. To be deductible:

   §167(a): Educational costs deductible if they 1) maintain or improve skills required by TP’s current employer and 2) meet provisions so that TP can maintain rate of pay.

**C. Depreciation**:

   §167: Depreciation Deductions: [Idaho Power: §263 capital expenditures trumps §167’s allowance of depreciation deductions. Capital expenditure was being made. You shouldn’t be allowed to deduct it now, even if you’re doing if yourself].

   i) **Problem of Disallowance of Deduction for Capital Expenditure**: Problem is Violation of Economic Neutrality. TPs will pay to have have others do the building.

   ii) **Effect of Idaho Power**: Idaho Power can put changes in basis.

   iii) **Depreciation Deduction must be for Business**: TP homeowner cannot deduct depreciation of home, it’s imputed income.

**D. Business & Personal Expenses**: [Pevsner: Clothing costs are nondeductible if they can be used outside the workplace, regardless of §162.]

   “Carrying On” §162: Comes down to “carrying on” and child care, business meals not part of that. Objective Disallowance of many things

   §274:

**D. Travel Expenses**: Tax policy holds that commuter costs are a function of where TP lives, not a function of job. However, some TPs may have to live in a certain place because of job.

   §162(a)(2): These expenses required to do job, duplicated because of job. It’s all deducted for administrative ease, must be away overnight to deduct to these things, can’t be for more than a year, must be business to business.

   §274(n)(1): Partial Disallowance.

   §274(k): Meals and lodging cannot be lavish, but travel can.

**E. Legal Expenses**:

   §212: Test of deductibility depends on origin of claim – it must be business, not personal. Source of claim, not consequences is important. [Gilmore]. Implicit “carrying on requirement.” Treatment of investment just like business. “In lieu of what were damages paid?”