

**INTRODUCTION****Statutory Interpretation Rules**

1. Follow all cross references
2. Look for Statutory definitions.
  - a. Locally – in the same section usually
  - b. Globally - § 7701 + following
3. If no definition, then legislature probably intended to adopt common usage.
4. If Common usage is in conflict with obvious purpose of the statute, the statutory purpose prevails – see *Old Colony Trust*.
5. The headings in the Code have no bearing on the meaning

**General Tax Policy Criteria**

1. Revenue effect on Treasury – Revenue Generation
  - Does provision cause a gain or loss in tax receipts?
2. Vertical Equity – Distributive Justice
  - Does provision maintain differences in the tax burdens b/w persons in differing circumstances? A regressive tax rate violates vertical equity because it places more burden on those making less.
3. Horizontal Equity – Distributive Justice
  - Does provision maintain similar taxation among persons in similar circumstances? Two persons with the same economic income (regardless of its source) must pay the same tax, or else there will be a horizontal equity violation.
4. Administrative convenience – Revenue Generation
  - Does the provision permit uniform, and low-cost enforcement?
5. Taxpayer Compliance – Revenue Generation
  - Does the provision minimize taxpayer dissatisfaction by limiting reporting costs, constraining administrative discretion, promoting simplicity, convenience in timing of liabilities, and the appearance of fairness?
6. Economic Neutrality (efficiency) – Economic Progress
  - Does the provision induce changes in the utilization of economic resources that make allocation of resources less like a no-tax world allocation? This policy often concerns itself with capital-lock-in or labor lock-in resulting from tax-free imputed income.
7. Economic growth – Economic Progress
  - Does the provision promote economic growth?
8. Economic Stability – Economic Progress
  - Does the provision ameliorate fluctuations in the business cycle? Generally the progressive rate structure is seen to have such stabilizing effects because average wages decrease during recessions (and tax rates decrease), but increase during growth periods (where tax rates will also grow).
9. Transitional Equity – Distributive Justice
  - Does the provision, if new, safeguard against interests that rely on the past and windfall gains or losses?

**Progressive Rate Structure §1**

*Statutory Framework:*

§1(a) and 1(c) tables

*Tax Policy:*

1. Every individual (living human being) should contribute
2. Economic Neutrality
  - Tax law should not interfere with economic decision making
  - Top tax rate is now 36.9% - was as high as 92%, will fall to 35% by 2006
  - With any tax on income, leisure will be tax-free and work will be taxed – creates a distortion exs. Work v. leisure, spending v. savings, consumption v. investment
  - Only Perfectly Economically Neutral Tax is a head tax – ex. Each person pays \$23k
3. Vertical Equity (Fairness)
  - Persons in different circumstances should be treated differently
    - § 1 calls for a Progressive rate – if you have a higher income you pay a higher proportion
      - o People w/ higher income have gained more benefits than those with lower income so they should pay more for the benefits – BUT even w/ regressive still pay more
      - o Progressive inc tax makes up for other regressive local/state/ SS taxes
      - o Also, because of ability to pay – rich can make so charge a higher rate
      - o Equal sacrifice – same paid for \$15k to pay \$100 as \$150k to pay \$50k
      - o Creates a system where the marginal rate will be higher than the effective rate.
      - o Additional earnings always result in additional after-tax income as long as the marginal tax rate < 100%

§1(f) of the code links the income barriers in the tax brackets to the annually adjusted CPI

### **Corporate Tax §11**

*Statutory Framework:*

§11(a) Tax on taxable income of every corporation

-Municipalities are corporations, but certain types of muni income is excluded under §115

(a) public utility or

(b) essential government function (IRS allows money mgmt to be part of this)

a. To define “essential” Courts look to:

- i. Precedent Case Law
- ii. Legislative History
- iii. Policy/ Purpose of Statute

- Policy trumps, and bank deposits aren't taxed b/c of federalism issues.

**Jurisdictional Basis of Tax** – citizenship, residence, source

*Statutory Framework:*

1. Citizens pay tax on their worldwide income

a. (U.S. one of two countries to use citizenship alone as a basis for Income Tax)

2. U.S. Residents pay tax on their worldwide income.

3. Foreigners (non-resident aliens) pay tax if income has ‘source’ in U.S.

Non-resident Aliens – Source Rules § 871, 877

Tax at 30% rate, if:

1. sources within U.S. AND
  - if >25% of corporate income from U.S.
2. Dividends, rents, etc. (periodical income) AND
3. Not effectively connected w/ conduct trade/business w/ U.S.

Tax under § 1 if:

1. Engaged in trade or business within U.S. AND
2. tax liability on income effectively connected w/ U.S. trade/business

Not general tax if:

1. Not effectively connected AND
2. Not from U.S. sources or Not periodic

- If renounced citizenship in last 10 years still subject to § 1, unless can prove bona fide reason for renunciation - §877

Benefits to each:

U.S. citizenship – benefits of state dept. abroad and embassies

U.S. residents – get full defense protection, constitution, etc.

Nonresident Aliens – get economic benefits from U.S. if income from U.S. corp or investment

Multiple Countries Claims on One Income

1. Treaties may give one country the right to tax (ex. Residence for tax on dividend, etc.)
2. Allow deductions or credits for taxes paid to foreign governments – used by U.S. gov't

### **Unearned Income of Minors §1(g) Kiddie Tax**

*Statutory Framework:*

- Applies to children under 14 with living parents

Tax on (Total Income – Net Unearned Income) §(g)(1)(B)(i)

Net Unearned Income = Unearned Income

(\$3500) – [\$500 (g)(4)(A)(ii)(I), 63(c)(5)(A) + \$500 (g)(4)(A)(ii)(II)] = \$2500

Taxable Income = \$3000 - \$2500 = \$500

*Tax Policy:*

Without Kiddie Tax, Keisha would pay only \$450. If entire tax paid by parents would be \$980.

Under the Rules she will pay \$775 (\$75 + \$700 (from (g)(1)(B)(ii))).

Purpose: To Dissuade individuals from shifting unearned income to their low-rate children

§1(g) does not apply to children over 14; or to earned income

### **Introductory terms**

*Statutory Framework:*

§ 63 Taxable Income = Gross Income – Deductions

- Not a tax on Gross Receipts b/c that is unfair

Terms for reductions from Gross Income

§62 non-itemized deductions (above-the-line)

§63(b) itemized deductions – taken as an alternative to the standard deduction

Standard deduction encourages individuals not to itemize for administrative convenience

Exclusions are functional equivalence to non-itemized deductions

Credit – cash back dollar for dollar (often given as a %, so not full dollar)

A deduction gives ‘more’ benefit to those in the higher tax brackets than a credit, which benefits all equally – deductions favor elitist charities

### **§1001(a) Gain or Loss**

*Statutory Framework:*

Gain or loss is calculated on the sale, disposition of property - §1011(a)

= Amount Realized (Money Received + FMV of any Property Received)

- Adjusted Basis of Property (Basis = Cost §1012) +/- adjustments)

§1012 doesn't look to where the money came from – tax-paid savings, loan proceeds, etc. all go toward the cost portion of the basis.

Is an ROC last rule

## **INCOME**

### **Introduction to Income - Old Colony Trust**

*Statutory Framework:*

Gross Income = all income from whatever source derived, including but not limited to following:

§61(a)(1) – compensation for services, including fees, commissions, fringe benefits and similar items

#### Scrambled Transaction

- Employer paying tax to IRS is equivalent to paying Employer, then having Employer pay tax.
  - This scenario is enrichment to TP, and therefore included in Gross Income.

#### Tax Policy:

Economic neutrality - economically equivalent transactions must be treated equally

- “Discharge by a third person of a legally enforceable obligation is equivalent to receipt by the person taxed.” – TP has other assets freed up from creditor
  - o Under Current analysis: Falls under §61(a) b/c it is enrichment and ‘realization’
- Must tax the one-step transaction the same as a two step transaction.
  - If not taxed would create incentive to rearrange compensation to pay creditors
    - o violate economic neutrality
  - If not taxed would allow high wealth individuals to negotiate contracts w/ tax free compensation plans
    - o Violate horizontal equity – two workers w/ same compensation would pay different levels of tax.
  - Court rejects common usage of “income” in favor of policy rationale
    - o B/c of problems w/ result from treating as tax-free under common usage above
  - Court rejects TP’s argument that tax paid is a non-taxable gift under §102(a)
    - o It was compensation for services, even though voluntary – not a gift
  - Ct. rejects TP’s argument that this scheme results in a tax upon a tax – w/o comment
    - o There is never a deduction for other federal taxes paid (see withholdings §275)

### Meals & Lodging

#### Statutory Framework:

In-kind income is taxable along with cash income §61

§ 119 provides for exclusion of certain “meals or lodging furnished”

this section overrules Benaglia, and the judge-made exception there

1954 Regulations 1.119-1 Defining ‘convenience of the employer’

For meals to be excludable:

1. must be served on business premises
2. are furnished for the convenience of the employer (“convenient/helpful”)

Lodging to be excludable: 1, 2 from above

3. Employee is required to accept lodging as a condition of employment.

§119(b)(3) requires that there is a **periodic** payment of a **fixed** charge

§119(d) University Presidents

- Taxes must be paid on 5% of the value of the in-kind housing.

§107 – Clergy (more relaxed standard)

Rental value of in-kind home, or rental income is excluded to a ‘minister of the gospel’

TP must be performing a real ministerial duty to get §107 exclusion

#### Case Law:

#### Benaglia

Rule: Compensation given in-kind is not taxable if given for the “convenience of the employer” – interpreted to be a business necessity.

Turner

If transferable goods:

Min enrichment = net resale value = fair market value (in TP's mkt) – cost of sale

If TP doesn't sell the in-kind goods, they are worth more to him than the FMV

If non-transferable goods:

Min enrichment = food, utilities avoided + subjective pleasure from goods

Tax Court adopts the Benaglia dissent (expenses avoided std., not the convenience of the employer standard)

Haverly

Free samples are taxable only at 'garage sale price' – so not enforced.

But TP may not take a deduction of retail price from donation of free samples.

Kowalski v. Sibra - Two conflicting cases of cash exclusions under 119.

*Tax Policy:*

Problems with not taxing in-kind income on hotel manager

1. horizontal inequity – an engineer is taxed on all income, even that spent on food/lodging
2. economic non-neutrality – creates preference for Ee to work in hotel industry over every other.

Should: Tax TP to the extent he is enriched. Find the subjective value to the TP for the in-kind goods and services. Too hard to administer

**Fringe Benefits**

*Statutory Framework:*

§132– allows for exclusion under 7 types of benefit

§132(c) employee discount – must be goods/services offered in the ordinary line of work, and discount cannot exceed gross profits of good or 20% of the retail price of services

Under 132(d) – must look to the primary purpose of the expense; if TP had paid for benefit out of pocket and could've deducted such an expense as a 162 business expense, the benefit is excludable.

Free supper and cab fare is generally excludable as de minimis if only occasional, and in association with working overtime – see Reg 1.132-6(d)(2)(i)

§ 132(j) Highly Compensated employees

no added cost services and employee discounts may not be given to highly compensated employees at a unequal amount.

A sole proprietor is not an employee, so cannot exclude any fringe benefits under 132, but partners are employee – Reg. 1.132-1(b).

**Imputed Income**

*Statutory Framework:*

- Tax Code does not call for a tax on imputed income (ex. Owner occupied housing)
- There was a deduction for child-care costs – now changed to a potential credit - §21
- Payment for services with services is income Reg. §1.61-1(d)(1)
- Still no tax for self-performance of services, or by other members of the household
- Barter exchanges are taxable and must be reported – carpools do not (admin. Discretion)

*Tax Policy:*

There is a horizontal inequity in not taxing imputed income

- (ex. tax benefit to owner of housing over renter)

1. Taxing both - Difficult to administer / enforce tax on imputed income
  - would need to estimate the rental value of every owner-occupied house
2. Taxing Neither - Distortion from income for a certain expenditure tax-free over any other
  - If no tax on income used for rent there would be a huge loss of revenue

There is a misallocation of resources ( ex. childcare from stay-at-home mom)

- If paid childcare costs are not deductible, there is an incentive to work, when it may be more efficient to stay home and care for children

## Damage Awards

### *Statutory Framework:*

- Compensation for “goodwill” is taxed as part of a forced sale as a capital gain (§1001(a))
- Compensation for lost profits is taxable income, just as the profits would be. §61?
- §104(a)(2) Exclusion from tax on any damages on account of personal physical injury
  - Punitive damages (pure windfalls) are still taxable – 104(a)(2)

Raytheon still applies to damages that don’t meet 104(a)(2) requirements (e.g. property or emotional damages)

### *Case Law:*

#### Clark

- A payment in compensation for a loss is not income, b/c not enrichment
- A third party payment of a liability is income (Old Colony), unless that third party caused the liability (Clark)
- Clark (who’s attorney error led to mistaken tax return) will have same tax liability, as if he had made a mistake on the return himself, even though if he made mistake himself he would’ve been out \$20k, and now he had that money returned to him.

#### Raytheon

Replacement Rule: “In lieu of what were the damages awarded?”

- In Raytheon, court uses forced sale, but says basis = 0, so all is taxable.
  - The “goodwill” was self-created, so no original costs, and all investment had been deductible at the time, so no adjustments to basis.
  - But capital gain taxed at lower rate (§1222/1221) than profits / income (§1)
- Is a factual consideration, as to what loss the damages replaced? (profits/goodwill/other)
  - (a) medical expenses paid out of pocket – not, replacing after-tax funds
  - (b) pain and suffering – not, replacing free-from-pain feeling – imputed income
  - (c) Lost wages – taxed, as if salary
  - (d) Future wages – taxable as lump sum salary payment
  - (e) Punitive damages – taxable – as windfall
    - Not Raytheon Rule, b/c not a replacement for anything, just manna from heaven

### *Tax Policy:*

Problems w/Taxing Clark’s compensation from tax attorney:

- violation of vertical equity – people in different economic situations should have differing tax liabilities
- Vertical inequity could be solved by allowing deduction for federal tax payments – but this is not necessary, except in the case of a mistaken return, and results in huge revenue losses for treasury

§104 excludes all personal injury compensation:

- Juries don't often allocate how much is due to profits and how much to injury, so it would be difficult to tax properly, so Congress has employed no tax at all.
- Would be negative politically to tax all compensation, so taxes none.
- Taxing a compensation package at once would result in over-taxation because of income bunching – the marginal tax rate would be too high
- Punitive damages leave no problem w/ allocation because most state courts require breaking up compensatory and punitive damages

## **Annuities §72**

### *Statutory Framework:*

General Rule: All income received as an annuity is Gross Income §72(a)

*Exclusion Ratio:* §72(b)(1)

= *investment in contract / expected return*

- Any amount received that is equal to the exclusion ratio is not included in GI

“investment in contract” = premiums + other consideration paid – amt received before annuity starting date §72(c)(4)

“annuity starting date” – first day of period where \$ is received

“expected return” = Annuity \* Life expectancy multiple (Table 1.72-9-V, p. 1046 if post-1986)

If TP outlives expectancy, the entire payment is then taxable as GI §72(b)

If TP dies prematurely, executor can deduct the unrecovered investment.

### *Tax Policy*

- Allows for tax deferral in a de facto interest bearing savings account

- B/c tax is applied equally throughout the life of the annuity, when there is really more interest income at the beginning than return of capital (so should be more tax at the beginning), and more return of capital than income at the end (should be less tax at the end)
- In a savings account, all interest income would be taxed every year, not only part at the beginning, but then making up for the deficiency at the end. (p. 36-37)

Economic Neutrality: Insurance bought annuities are tax favored over commercial savings acts.

Return of capital first rule

Return of capital last rule

Pro-rata return of capital rule \* chosen by Congress currently under §72

Backloaded return of capital rule

Frontloaded return of capital rule

**Term Insurance** (pure insurance – premium for a short, fixed period of protection against death)

### *Statutory Framework:*

- All life insurance proceeds are tax-free §101(a)(1)
- Life insurance premiums are taxable (no deduction).
- Tax-free amount limited to aggregate premiums §101(a)(2)
- Proceeds paid to terminally ill patient are tax-free §101(g)
- Interest on proceeds put in savings account is taxable §101(c)
- Excess income on an annuity bought with proceeds is taxable §101(d)

### *Tax Policy:*

Should look to what the insurance replaces

- If replaces income, should be taxable under Raytheon rule.

- If replaces imputed income (homemaker) would not be taxable
- If beneficiary is wage-earning adult, is a bequest, should be tax-free under §102(a)

But too hard administratively to sort out what the insurance proceeds really respond to

To minimize unfairness:

- Could tax all – b/c most people buy insurance as a wage replacement
- But, that would not be popular with widows, so Congress chose to tax none:

**Whole Life** (term + savings – protection against death and get face value if outlive period)

- Premiums go to (1) term insurance, (2) deposit in savings account
- Policyholder can generally surrender the policy for its cash value at any time.

*Statutory Framework:*

- If proceeds are paid at maturity, there is a tax on ROC (only tax deferral) §72(e)(1)
- If proceeds paid at death, even a day before maturity, no tax §101(a)(1)

*Tax Policy:*

- commercial bank savings accounts – no deduction for deposits, and taxation on interest.
- By failing to tax accrual until maturity, , whole insurance savings allows for tax deferral of all the interest payments during the time of the investment.
- Creates Problems w/ Horizontal equity and economic neutrality – treating life insurance savings different from commercial banking savings.

## **Loan Proceeds and Repayment**

*Statutory Framework:*

General Rule: Proceeds from a loan are received tax free - §61(a)

- Similarly, the re-payment of the principal is not deductible

Interests payments are generally deductible because there is disenrichment §163(a)

Income from the discharge of indebtedness is taxable §61(a)(12)

- codification of Enrichment Rationale from Kirby Lumber

Discharge of indebtedness is not income if TP is insolvent or in bankruptcy §108(a)(1)

- codification of the insolvency exception

- Amount of exclusion is limited to amount by which TP is insolvent §108(a)(3)

- AND Net Operating Loss deductions are reduced by §108(a)(1) exclusions §108(b)(2)(A)

Basis is also reduced by any remaining indebtedness §108(b)(2)(E)

Dollar for dollar reductions in tax deductions and 33% reductions in tax credits (b)(2)(B, C)

§108 is the only insolvency exception (none by courts) §108(e)(1)

“Indebtedness of the taxpayer” is defined as “any indebtedness – (A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property.”

*Case Law:*

### Kirby Lumber

- Corporation had taxable gain when it bought back its corporate bonds at a discount because of increased interest rates.

1. Enrichment Rationale: Income b/c some assets were freed from claims of all creditors at time of buyback.

- This rule is codified by discharge of indebtedness rule §61(a)(12)
- Exception if the corporation was insolvent both before and after buyback.

2. Recapture Rationale: Income b/c loan proceeds received tax free due to obligation to repay were not in fact repaid. No insolvency exception.

Zarin

- gambler settles \$3.5M debt was for \$500k; does not need to pay tax on the \$3M forgiveness
  - This was only a “price adjustment” b/c he didn’t receive \$3.5M in value from the chips, and casino should have known that it wouldn’t be repaid for the whole amount.

Tax Policy:

No tax on loan receipts or deduction for re-payment in general

1. No enrichment – just conversion of the form of wealth
2. Administrative convenience – both ends of transaction have no effect on tax – easy to ignore
3. Problem of income bunching in the year you receive income

§108 Insolvency exception to the discharge of indebtedness is only tax deferral, because future income will be increased by disallowance of Net Operating Loss carryovers

Congress will not tax the debtor in the year of discharge – but will tax (nearly fully) in the future.

**Gifts and Bequests**Statutory Framework:General / Cash Gifts

Gifts are excluded from tax for the donee §102(a)

Gifts are not deductible by the donor (taxed) – as opposed to charitable gifts §170(a)

- Congress taxes the donor, not the donee

-Only the value of property in a gift is excluded, not the income from the property §102(b)(1)

Gifts of Income / Life Estates

- A gift of income from property is taxed (not excluded) §102(b)(2)

- codification of Irwin v. Gavitt

- The donee of an income interest cannot claim any depreciation deductions §273

- A buyer of the interest would be able to deduct depreciation

§102(a) and §273 together mean a donee of income will pay tax on every penny

- Donee’s adjusted basis for a life estate, estate for years, or income interest is zero §1001(e)

- BUT if the donee takes property at death, the basis is the FMV at death §1014(a)

- over time the life tenant’s basis decreases, and the remainder-man’s basis increases 1014-5

In-kind Gifts

General basis rule: Donee will take the donor’s basis in the property gift §1015

If transferred basis > FMV at time of gift; to *determine loss*, basis = FMV §1015(a)

- If sale price is b/w carryover basis and FMV, there is neither gain nor loss §1015(a)

Death time donative transfers

- not realization on gift upon bequest §102(a)

- if the donee takes property at death, the basis is the property’s FMV at death §1014(a)

- There is tax FOREGIVENESS of appreciated property for the beneficiary.
- Also disallowance of deduction for a loss
- 1014 saves the public \$37B each year

- Post 2009, §1022(a) in conjunction w/ elimination of estate tax, calls for a carryover basis at death if the aggregate basis > \$1.3M

Prizes & Awards

- Gross Income includes prizes and awards §74(a)

- prize can be excluded if for scientific achievement and donated to charity §74(b)

*Case Law*Irwin v. Gavit

- Where the gift is a stream of income, the gift is not excluded

Early

- Income settlement from a claim to a bequest is treated as a gift under Raytheon rule.

Taft v. Bowers

- gift of appreciated stock from uncle to niece – Is this an realization event?

- No – donor is not taxed at time of gift.

*Tax Policy:*

1. Material Consumption view – Don't tax Donor, Tax Donee

- Donor gets no material benefit from the gift giving

- Donee gets clear enrichment - §61(a) – Glenshaw Glass

2. Intangible Consumption view – Tax Both

- Donor gets intangible benefits from giving the gift

- utility from gift is greater than if she kept it herself

- The gift is consumption, should be treated as such.

- Donee again gets clear enrichment - §61(a) – Glenshaw Glass

Congress chose neither (1) nor (2), but to tax Donor only.

1. Why not Material Consumption view (taxing just donee)?

- Would be less revenue than taxing donor

- Most gifts are from wealthy to poor. Taxing the donee, and allowing a deduction for the donor would mean the Treasury would collect a lower tax rate on each gift.

2. Why not Intangible Consumption view (taxing both)?

- Administrative difficulties / Result in massive non-compliance.

- If donor cannot claim a deduction from donation, there would be no incentive to report the gift, and then donee wouldn't get taxed either

- Donee would be unlikely to voluntarily report the income.

Why Congressional method (tax donor only)?

1. Administrative convenience

- No reporting necessary – but no deduction

2. Donor tax as proxy for donee tax

- Congress may prefer material consumption view – but they tax donor to preserve the progressive rate structure

3. Donor tax as next best thing to taxing both.

- Congress may prefer intangible consumption view – but b/c it's difficult to tax the donee, we are left with a tax on the donor only.

§1015 Transferred basis rule: (defined in §7701(a)(43))

- Taxes the donee at the time of subsequent sale on both her gains, and the appreciated gains of the donor

- Causes tax deferral and income shifting (original accession was to donor)

- Causes a massive reduction in the taxes paid

- Gifts are typically from wealthy (higher tax rates) to poorer (lower tax rates)

Do not allow carryover basis for the computation of losses:

- Congress already gives shifting of gains (income) to the lower tax rates (see above), they do not also want to give shifting of losses (deductions) to the higher tax rates.

Conclusions:

Cash Gifts: Are taxed only to the donor by not allowing a deduction

In-kind Gifts: (1) tax donor (earlier) to the extent of the adjusted basis ?that is lost?

(2) tax donee (later) to the extent of appreciation in the gift's value

(3) tax neither now at the time of the gift.

Why Tax forgiveness at death? §1014(a)

1. Liquidity Concern

- a tax on valuable property may cause widow to need to sell the farm to pay the tax
- even with "carryover basis" – still may have so much appreciation that liquidity is prob.

2. Capital Lock-in / Economic Neutrality

- Realization requirement leads to tax deferral, which leads to huge appreciation, which dissuades TP from selling property, even if another investment is more efficient.
- Can solve liquidity concern w/ carryover basis, which makes capital-lock-in worse
- Can solve capital-lock-in with realization at death or gift /bequest, but that causes huge liquidity problems.

Alternative Proposal: Realization at death w/ installment payment of tax

- No capital lock in past 1 generation
- tax is paid in installments, so there is no liquidity concern

Prizes & Awards

- should be treated as a gift if given w/ no TP effort – would be tax free §102(a)
- should be treated as compensation if TP expended effort – would be taxed §61(a)(1)
  - Congress taxed as windfall – Glenshaw Glass, manna from heaven.

## Business Gifts

*Statutory Framework:*

If a "gift" is deductible as a business expense, the donee must pay the tax §274(b)

Any "gift" between an employer and employee is compensation and taxable §102(c)

*Case Law:*

Duberstein

Court: When there is a mixed motive transfer look to the transferor's *primary purpose*

gift: detached and disinterested generosity

compensation: constraining force of any moral or legal duty or incentive of anticipated future benefit.

*Tax Policy:*

This is a mixed motive transfer.

Proper treatment is the unscramble the transaction and tax the receiver for the amount that is compensation (allow as deduction to grantor), and do not tax the receiver for the amount that is a gift (no deduction to grantor).

## Realization Requirement

*Statutory Framework:*

Gross Income "includes (3) Gains derived from dealings in property" §61(a)(3)

"Gain from the sale or other disposition of property..." §1001(a)

- There is no tax until sale or other disposition
- The statutory language, generally requires that there be a *transaction* p. 74

Stock dividends are not taxed (affirms Pitney majority) §305(a)

- exceptions, including if choice b/w stock and cash dividend §305(b)(1)

- or if there is a change in the substance of the ownership §305(b)
  - at sale, the basis for each share is the proportional part of the cost of the originals §307
- Improvements on property are not gross income to landlord (overrules Bruun) §109
- BUT landlord cannot adjust his basis – acts as Tax Deferral only §1019
  - Also landlord cannot take any future depreciations or deductions on improvements
- Tenant improvements in the nature of rent – if “bargained for” are taxable §109
- In this case, the improvements are rent ‘in-kind’

*Case Law:*

Eisner v. Macomber

Pitney (Majority): Income is gain derived from capital

- TP gains nothing from tax dividend, so it is not income

Brandeis (dissent): that stock dividend should be taxed just as the cash dividend.

Pitney: Stock dividend more like reinvested profits, than cash disbursement., this is a purely formal transaction.

Brandeis: Congress could tax undistributed profits if it wanted under 16th Amendment.

Helvering v. Bruun

- Realization need not be in cash derived from a sale
- Tax will be imposed when the *transaction* is complete, in that control has transferred
- Test of control: has TP separated his risk from the investment?
  - Landlord will include improvement in adjusted basis at time of sale – no double tax.
  - Landlord also gets to deduct depreciation from rent.
- Specific ruling overruled by §109, but rationale for realization still stands

Cottage Savings

- Any exchange must be between two “materially different” interests to be a realization event
- The properties must embody *legally distinct entitlements*, for TP to realize gain / loss
  - “legal entitlements that are different in kind or extent”
- The SL transfers here was a realization event b/c TP risks and liabilities were transferred.
- Court says: §1031 would’ve been unnecessary if like kind property could be swapped without having a realization event under constitutional test.

*Tax Policy:*

- Realization requirement is only tax deferral, TP will still pay tax on full value upon sale, and will have no additional basis to subtract.

- *Unrealized appreciation is not taxable*, nor is increase in value of capital investment

Why the realization requirement?: - An administrative rule, not constitutional, nor economic

1. Administrable
  - Too hard to assess the FMV of every piece of property, etc. every year
2. Liquidity Concern
  - May not be able to pay the tax before the sale b/c not enough cash on hand
  - requiring a forced sale to pay the tax would be unpopular

Problems w/ realization requirement:

1. Vertical equity – fairness
  - Wealthy TP who can afford to re-invest dividend gets to defer taxes
  - Poor TP who needs the annual dividend to survive, must pay taxes annually.

TP in Bruun, argued that landlord should not be taxed for tenant’s new building on property

- Would only result in a tax deferral – Landlord would be taxed on gain at time of sale
- Also Landlord wouldn’t get a depreciation on rental payments

Cottage Savings court renounces the Constitutional basis for realization requirement

- Sees it as an administrative rule.

### **Stock Dividends** – from Eisner v. Macomber

*Statutory Framework:*

General Rule: stock dividends are excluded (not taxed) §305(a)

- exceptions, including if choice b/w stock and cash dividend §305(b)(1)
  - generally taxable if there is a change in the substance of the ownership §305(b)
- Upon Sale, the statute calls for basis to be the total original cost / current number of shares, for any of the shares sold, regardless of which ones §307

*Tax Policy:*

Dividends are generally subject to a “double taxation”

- Profits are taxable to corporation when earned, and not deductible upon pay-out §11
- AND are again taxable to stockholder upon receipt §61(a)

Passthrough tax on LLC's and partnerships: §§ 701, 702, 731(a)(1)

No tax on firm; tax to owners on profits; no tax on distribution

### **Divorce Settlements**

*Statutory Framework:*

- Property transfers between spouses or at time of divorce are not recognized §1041(a)
  - Recipient takes the property tax-free BUT
  - Basis on the property carries over from the transferor to the transferee §1041(b)(2)

*Case Law:*

#### Davis

- The transfer of property from husband to wife in exchange for a forfeiture of marital right to sue is a realization event.
- To calculate amount realized, must add the cash the wife paid (\$0) plus the value of her release
  - FMV of her release can be assumed to equal the value of the property paid b/c at arm's length

#### Sultaneh

- A transfer of stock during pre-nuptial agreement that will be in lieu of any divorce settlement is given a basis of the FMV at the time of the transfer, not the carryover basis
- Davis and Sultaneh are overruled (in 1984) by §1041(b)(2) – calls for carryover basis

*Tax Policy:*

How would Mrs. Davis be taxed?

- Cannot treat the settlement as an exchange b/c it is not a market transaction, because she could not sell her marital rights to anyone except her husband.

Should look to what the settlement is in lieu of – Raytheon Replacement Rule

1. In kind support – food, shelter, clothing, etc.
    - treated as a gift, so not taxable §102
  2. Intangible support – consortium, love, help w/ home etc.
    - imputed income, not taxable §61
  3. Share of spouse's property at death: inheritance b/c spouse is heir under statute
    - treated as a gift, bequest at death – not taxable §§104, 1014
- So theoretically, she should not be taxed, and has not by Congress.

Her basis in the property is its FMV at time of receipt

§1041 carryover basis allows for tax deferral of the appreciation in property, and also shifting of the tax burden from the transferor to the transferee (who will pay tax on sale of property).

- This shift leads to less tax revenue as transferee (wife) usually has lower marginal tax rate than transferor (husband)

Davis and Sultaneh led to massive non-compliance, because husbands wouldn't declare income upon giving up property, and wives didn't have to pay under the FMV basis rule  
Treasury likes §1041 b/c they can collect some tax, even if later and at a lower rate.

## Periodic Divorce Payments

*Statutory Framework:*

Alimony is income to the payee §71(a)

Alimony payments are deductible by the payor §215

Alimony is any cash payment if: §71(b)(1)

- paid under a divorce
- divorce cannot provide that payment is tax is to be made by the payor
- Ex-spouses must live apart
- there is no liability to any future payments

If the payment is in-kind, it does not qualify for alimony – nonrecognition §1041

Re-capture rule will prevent the deduction of a one-time divorce payment, if the payor pays more during the first year than the average of the 2nd and 3rd years. §71(f)

Excess pmts for 2nd yr = 2d yr pmt – (3d yr pmt + 15K) §71(f)(4)

Excess pmts for 1st yr = 1st yr pmt – {[2d yr pmt – 2d yr excess + 3d yr pmt]/2} + 15K}

Child support: Is not deductible by the payor, nor included by recipient (like property transfer)

- Will not treat payments as alimony if they are called child supports §71(c)(1)
- Payments are not “alimony” if tied to a contingency related to a child §71(c)(2)A)
- If payment can be “clearly associated” with a child’s contingency it is not alimony §71(c)(2)(B)
  - Regulations define “clearly associated,” esp. cases of 2 or more children.

*Tax Policy*

§71(b)(1)(B) allows TP to shift the tax burden from the payee to the payor

- Provision encourages divorcing parties to shift the burden from the higher tax rate party to the lower tax rate party (which is usually the payee)

Alimony Criteria are very formalistic – if followed the recipient pays the tax

Formalism allows for administrative convenience

- But easy to formulate a divorce settlement as “alimony” and put tax on recipient
  - Example: Make three equal annual payments (avoids §71(f))

## DEDUCTIONS

### Business Expenses / Capital Expenditures

*Statutory Framework:*

Can deduct all the “ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business” §162(a)

No deduction is allowed for permanent property improvements §263

- Capital expenditures will be deductible later through:
  - (1) depreciation §167; (2) loss deductibility §165; lesser basis §1001(a)

Personal / Family expenses are not deductible §262

Public Policy Disallowances

Bribes and kickbacks are not allowed as deductions §162(c)

- disallowance for any illegal payment §162(c)(2)

Legislative, or executive lobbying or campaign funding are not deductible §162(e)

- exception for local legislative lobbying §162(e)(2)

No deduction for any fine or penalty paid to government §162(f)

No deduction for 2/3 of anti-trust law treble damages, if  $\Delta$  previously found guilty of illegal conduct §162(g)

No deduction for expenses of illegal drug distribution §280E

Capital Expenditures

Ordinary repairs are deductible §162

Improvement / betterments (property whose useful life extends substantially beyond the taxable year) are not deductible now §263(a)

§261 calls for §263 disallowance to trump §167 deductions.

Cost Recovery

- depreciation deduction §167(a)
  - reasonable allowance of exhaustion, wear & tear if property is used in business / investment activities
  - No depreciation for personal expenditures
    - also no deduction for personal loss §165(c)
  - As you take depreciation deduction, you have an offsetting deduction in adj basis
- Amortization § 1016(a)(2)
- Basis offset on sale – computing Gain/Loss §1001(a)
- Loss deduction §165(a)(c)

Case Law:Welch

Necessary expenses – “appropriate and helpful” – a lenient standard

Ordinary expenses – common or typical in the business world

- TP’s expenditures were not ordinary, because they were capital expenditures made to acquire or improve his good business reputation – not deductible under §263.

Tellier

“Where the allowance of a deduction would ‘frustrate sharply defined national or state policies proscribing particular types of conduct,’” courts will disallow a deduction.

Mazzei

- Judge-made court disallowance survives – even after §162

Mt. Morris Drive-In

- Court determines that a drainage ditch was a capital improvement.

- If built at time of construction it would’ve been improvement – should treat same
- Is an independent piece of property that will have future utility
- (6th Cir) – will extend economic used life of the property

Dissent:

- There is no substantial betterment to the land
- (6th Cir) – If payment directly to neighbor as settlement would’ve been deductible.

Idaho Power

- Trucks used to build power plants must be treated as §263(a) capital investment, and so are deductible over the life of the power plant, not the life of the truck

*Tax Policy:*

## Education Expenses

1. Skills maintenance – continuing education classes.
    - deductible under §162 b/c “appropriate and helpful” and “maintain skills”
  2. Acquiring new skills – law school tuition
    - not deductible now §263 b/c investment in a new trade
    - maybe deductible later through depreciation §167
  3. Recreation – Arts course
    - not deductible §262 – personal consumption expenses.
- Congress does not allow for deduction b/c education knowledge is not property under §167  
Through §162 Congress tells the courts that we make disallowances, not you.

## Why treat truck as capital expenditure?

1. Economic neutrality
  - TP could pay other company to build plant, then would have to include total cost as capital improvement
2. Statutory Justification
  - §261 calls for §263 disallowance to trump §167 deductions.

**Personal and Travel Expenses***Statutory Framework:*

Personal, living, or family expenses are not deductible §262

Costs of uniform for work are deductible, but not other clothing Treas Regs.

Commuting costs are not deductible §162

All (overnight) traveling expenses when away from home are deductible §162(a)(2)

- Can only deduct 50% of meal costs – b/c would have to eat anyway §274(n)(1)
- Transportation remains deductible even if not overnight §162(a)(2)

If travel time >1 year is not deductible – bright line rule §162(a)

Cannot deduct “lavish and extravagant” meals and lodging §162(a)(2)

- Cannot deduct any “lavish and extravagant” business meals §274(k)
- cannot deduct business travel on a cruise ship §274(m)(1)

*Case Law:*Smith

Court disallowed childcare deduction for working mother, because the cost was a personal expense.

- should have never qualified as a deduction under §162(a) b/c not part of “carrying on”

Pevoner

- Clothing costs of high-end retail saleswoman are disallowed under §262

- court refuses to look at the individual TP who won't wear them after work.

Gilmore

- Attorney fees / damages are deductible only if the *claim originates* in a business or investment capacity (not the *resulting consequences* of the suit have business effects)

- if the source of the claim is person, the costs are not deductible §212
- Court reads in an implicit “carrying on” requirement in §212

*Tax Policy:*

$$Y = C + \Delta W$$

Income = Consumption §262 + Change in Wealth (Savings §263)

Sources = Uses

Childcare costs – should look to the starting point:

If TP is first a career woman, then has children – the childcare costs are personal choice

If TP is a mom first, then has to get a job – childcare costs are necessary expense of having a job

- Not feasible to make this distinction, so Courts should choose rule that minimizes unfairness

- Now many more are career woman first, so childcare probably are personal expenses

Commuting Costs – are not “carrying on” any trade of business – will not increase profits

- This rule assumes that TP has a fixed job location and can move home
- What about TP whose home location is fixed, and must look for work, still not deductible

## Health Care Costs

*Statutory Framework:*

### 1. Employer paid health care

- The premium payments are not taxed (excludable – largest \$ in the Code) under §106
- Proceeds are not taxed (excludable) under §105(b)

- This is enrichment – same as employer paying employee cash, who then buys own health insurance – The 1-step transaction should be treated like the 2-step transaction

### 2. Employee purchased health plan

- Premium payments are not taxed (limited deductible) under §213(d)(1)(D)
- Proceeds are not taxed (excludable under §104(a)(3))

### 3. Employee Self-Insurance (pay as harm occurs)

- There are no premiums
- Proceeds (payments) are not taxed (limited deduction under §213(a))

- Except for 213 limitations, all expenditures for medical care are tax-free

### §213 Limitations

1. Can only deduct “medical care” payments greater than 7.5% of AGI
2. Medical cost deductions must be itemized, so not benefit unless aggregate exceeds the standard deduction.

*Case Law:*

- For a dual purpose expenditure, Congress does not sort out the relative benefits of the expense as related to personal and medical benefits, which would be the proper treatment.

- Court looked to see if expense was “directly” related to medical cost – Ochs.

*Tax Policy:*

1. Incentives: Employer paid policies are the only ones to be tax-free on both ends (b/c of limitations on employee premium deductions and self-insurance deductions). An incentive to have employer paid policies over employee paid. Gives something for unions to bargain for.

2. Moral Hazard Problem: With unlimited employer insurance, there is no marginal cost for each procedure, so little incentive to forgo additional health care, even if very costly.

3. Self-Insurance Favor: The framework favors self-insurance over employee purchased insurance. B/c (2) will only be able to deduct premiums if they fall above 7.5% annual GI (which is rare), while (3) can deduct medical payments also when they fall above 7.5% of annual GI, which is typical if there is an illness.

Non “Medical Care” Health Insurance – Primary Sick Pay Insurance

### 1. Employer Paid

- Premiums are excluded under §106, Proceeds are taxed §105(a)

### 2. Employee purchased

- Premiums are taxed (non-deductible) §213(d)(1)(D), Proceeds are not taxed (§104(a)(3))
3. Self-insurance
- No premiums, Proceeds are taxed (§213(d)(1)).

## TAX ACCOUNTING

### Tax Timing

#### *Statutory Framework:*

Taxable income shall be computed under TP's regular method of accounting §446(a)

1. Cash receipts and disbursement method §446(c)(1)
  - Include all actual or constructive cash receipt.
2. Accrual method §446(c)(2)
  - Include all events that occurred which fix TP's right to income
  - Include all amount of income that is reasonable estimable

Taxable income shall be computed on the basis of TP's taxable year: §441(a)

losses can be carried back 3 years preceding the loss year, and forward 15 years §172- (p. 260)

- Codified in §111 Tax Benefit Rule??

§172 –

#### *Case Law:*

Even though there may be an overall loss on a project, TP must pay taxes if there is enrichment in a later taxable year – Sanford and Brooks

- This statute is constitutional, because it comports w/ 16th Amendment, which assumed an annual accounting period, although may be unfair that TP didn't get benefit of earlier losses and now has to pay for later gains.
- Replacing income that had already been taxed (purchase price for stock) is tax-free - Dobson
- Congress mitigated the Sanford result w/ §172 Net Operating Loss carryover provision

#### *Tax Policy: (Tax Benefit Rule)*

Inclusionary side to Tax Benefit Rule – inclusion of income to off-set erroneous deduction

- Earlier losses are generally deductible §164(a) and (c) – disenrichment
- Gains are generally included §61(a)(3) – enrichment
- When TP receives a settlement to off-set the earlier loss, TP is no longer disenriched, so the settlement must be treated as income to off-set the deductions –
- tax benefit rule (Sanford and Brooks) rules, except for case under §172. See §441

Exclusionary side of Tax Benefit Rule –

- TP took deduction that was incorrect, but we do not fix it because the error was harmless in terms of tax liability

### Claim of Right Doctrine

#### *Statutory Framework:*

If income (>\$3000) is reported as a claim of right, then TP has to pay it back,

1. TP can take deduction when repaid, OR §1341(a)(4)
2. reduce present tax by the amount overpaid in previous year §1341(a)(5)

#### *Case Law:*

#### North American Oil

- TP received royalties through court order in 1917, but final appeal was not dropped until 1922.
- Court: Royalties are taxable in 1917 b/c TP had a claim of right at that time, if they had been forced to give back the royalties in 1922, they would've been fully deductible then.

rejects TP argument that 1917 payment was a contingent loan obligation, not to be taxed until 1922

- Not a loan, which comes with an unconditional obligation to repay – and would allow for tax deferral

Rule: Unless obligation to repay is certain, there is no loan treatment.

- an obligation to repay that is not certain, must be taxed upon receipt, then deducted if repaid.

Lewis

Doctrine applies, even if it does not make TP whole because of rate changes

- TP reported \$22k in 1944 at high rates, then forced to repay \$11k in 1946, could only get a deduction at the then lower rates
- Problem solved by Congress in creating §1341(a)

James

Court: Under the claim of right doctrine, embezzled funds are treated as cash flow, not a loan—tax on receipt, then deduction when repaid.

McKinney

- No “unconditioned right” to funds, so TP does not get §1341 relief, after he repaid embezzled funds, but was not made whole by the deduction.

- Cannot get carryover loan relief under §172(d)(4) because the losses are not related to trade or business

*Tax Policy:*

Claim of Right:

1. Theoretical: Income is only partially offset by possible obligation to repay
2. Practical: Courts want to prevent TP from asserted dubious conditions on a payment and receiving tax deferral. (ex. Prof’s salary could be forced to be repaid in later suit by Dean, etc.) Would be administratively unfeasible to look into every asserted contingency.

Embezzler:

Should treat the embezzler like a borrower. - No tax at receipt, no deduction at repayment

BUT: Embezzlers don’t usually repay

Because the obligation to repay is not certain, claim of right doctrine applies, and the embezzled funds are taxable at the time of receipt.

## **RECOGNITION OF GAINS AND LOSSES**

### **Non-recognition Rule of Property Exchanges §1031**

Tax on a non-recognized gain will be deferred until the time of sale.

Tax on a non-recognized loss will also be deferred until the time of sale.

*Statutory Framework:*

General Rule: No gain or loss shall be recognized if: §1031(a)(1)

1. there is an exchange AND
2. property traded is for trade / business / investment AND
3. Solely for property of like kind AND
4. the received property is for productive use in trade / bus / investment

- Statute also provides for certain properties that cannot be exempted §1031(a)(2).

- No non-recognition for inventory swap - §1031(a)(2)(A)
- Real estate for real estate is always “like kind” §1031(a)(2) and Regs

- Personal property for personal property will be ‘like kind’ if in the same depreciation class or product class Reg. §1.1031-2

If exchange is for like kind property and other non-like-kind property (“boot”): §1031(b)

- Gain, if any, shall be recognized not in excess of the FMV of the “Boot”
- Loss will not be recognized if there is boot in the exchange §1031(c)
  - Basis rule will allow loss to be recognized at time of sale.

Basis of Properties Received = §1031(d)

Basis of property given up – money rec’d + recognized gain – recognized loss

Basis for the Boot = the FMV of the boot at time of exchange §1031(d)

Basis for Like Kind Property = Total Basis of Properties Received – Basis to Boot

§1031(a)(3) requires swapped property to be identified w/in 45 days, and rec’d w/in 180 days

- Avoids problems that came about after Alderson

*Case Law:*

Alderson

Court allowed non-recognition exchange when owner of apartment acquired apartment in an exchange for land that he had just previously bought. – This is a manufactured transaction.

*Tax Policy:*

Rationale behind non-recognition:

1. Administrative Convenience – avoid controversies of valuations, which are easy at sale
2. Taxpayer Compliance – If taxed an exchange on all gain at time of transaction, could require TP to sell the property to pay the tax, because TP may not have enough cash on hand. If no liquidity, would people comply?
3. Horizontal Equity – Congress will not tax a continued holding of Blackacre under the realization rules, so it does not want to tax an exchange, which is just a technical realization.
4. \*\*Economic Neutrality – TP would be dissuaded for swapping Blackacre for Whiteacre, even if Whiteacre is a better investment (higher % return) because of tax concerns, if income from the exchange was recognized. Tries to avoid the problem of “capital lock-in”

Congress created non-recognition for exchanges of land and others, but not stock.

1. Practical – grant tax deferral until land is sold, but if given for stocks, the wealthy could defer tax forever by continuing to trade stocks without realizing any gain
2. Theoretical – GE stock for GM stock is not ‘like kind’ b/c corporations are so fundamentally different.

Does not allow non-recognition for inventory swap

1. no problem with valuation of clothes, etc.
2. No liquidity concerns
3. Horizontal Equity – no capital lock-in concerns, because objective is to sell inventory, not to hold onto it for long-term investment

Boot:

- It is fair to tax to the extent the exchange is a withdrawal from the previous investment, which it is in the case of an exchange including “boot”

- If investment is kept in substantially similar investment (like kind) it is not taxed.

The basis rule for the “boot” will permit any realized loss from a not solely-like-kind exchange to be recognized at the time of sale.

**Non-recognition of Involuntary Conversion §1033***Statutory Framework:*

- If the property is converted into similar property, gain is not recognized. §1033(a)(1)

- If property is converted into cash, gain is recognized as follows: §1033(a)(2)

Maximum Recognized Gain § 1033(a)(2)(A)=

Amount Realized on Conversion (Total Sales Proceeds)

– Cost of Replacement Property

§1033(a)(2)(A) requires that the replacement property be:

1. acquired within the timing rules of 1033(a)(2)(B)
2. “similar or related in service or use” – stricter than “like kind”
3. If taken property was for business, replacement need only be of “like kind” §1033(g)

Basis = Cost of replacement (similar property) – (unrecognized gain) §1033(b)(2)

*Tax Policy:*

§1033 taxes any enrichment that is taken out of the property on the forced sale.

1. Administrative Convenience – Valuation is not a problem
2. Liquidity Concerns – Not a problem of taxpayer compliance
3. Economic neutrality – will not create a capital lock-in problem
  - None of 1-3 support tax deferral under 1033
4. Horizontal Equity – economically similar events, should be treated similarly – if no recognition on exchange, should not be recognition on forced exchange.

**Non-recognition of sale of Residential Property §121***Statutory Framework:*

- For almost all of the population, residential home transactions are exempt from tax.

- If TP lived in home for 2 of the 5 years before sale, TP can exclude up to \$250,000 gain.

- The exclusion is increased to \$500,000 for married couples filing jointly §121(b)(2)

*Tax Policy:*

This is Tax Exclusion, not just tax deferral b/c there is no corresponding basis rule

1. Congress was worried about capital-lock-in concern, which would distort economic neutrality if home owners were taxed on all gain upon the sale of their primary residence.
2. Congress is also buying votes – tax favored status to middle income homeowners
3. There is some incentive to sell your home when it’s appreciated and move more frequently, because your gain can be realized without tax consequences (especially if gain is approaching the \$250k plateau.

**Disallowed Deductions for Family Sales and Wash Sale §267(a) and §1091***Statutory Framework:*

- Any realized loss, as calculated in §1001(a), is deductible §165(a)

- Deductions from a loss on a sale or exchange to related individuals is disallowed §267(a)

- related individuals as defined in §267(b), family as defined in § 267(c)

- §267 disallowance trumps §165 deductions §261

- Any gain will only be recognized to the extent that it exceed a loss unrecognized under §267(a)

Wash Sale – no deduction is allowed for loss of sale of stock if you re-buy same shares w/in 30 days either before or after the sale (total window is 61 days). §1091

New Basis = new cost + disallowed loss §1091(d)

*Case Law:*

*Tax Policy:*

§267 creates a tax deferral, and a shift in the tax from the seller to the buyer

§1091 is just tax deferral b/c the disallowed loss is added to the new basis, so full loss will be recognized at the time of sale.

**Mortgage Borrowing (Standard and Nonrecourse)**

Nonrecourse Loan - lender provides cash for security interest in property, but does not seek promise from borrower to repay the loan.

*Statutory Framework:*

A standard subsequent loan will have no effect on the basis

- unless loan is used to improve the property, then include improvements §1016(a)(1)

Amount realized will include the cash received + FMV of “any other property” §1001(b)

- “any other property” will include the assumption of liability from a mortgage.

Nonrecourse: For calculating “gain or loss” FMV of property is at least the amount of the nonrecourse indebtedness §7701(g)

- codification of the Tufts majority

*Case Law:*Crane

“Amount Realized” = cash + FMV of property / services rendered

+ (1) the amount of any personal liability of the seller *that is paid by or assumed by the purchaser*

+ (2) the amount of any liability (whether recourse or nonrecourse) that encumbers the property *and to which the property remains subject after the transfer.*

So, the two methods of selling a mortgaged property are still treated equally, if the loan is nonrecourse. Even if B only pays A \$200k, and the mortgage is non-recourse, A has still realizes \$1.2 M in forgiveness of indebtedness.

- See Crane handout for court’s two rationales

The mortgage amount must be added to the seller’s cost to compute the adjusted basis.

Tufts

Majority: Gain = Nonrecourse Mortgage Value – Adjusted Basis - codified

O’Connor (right): Discharge Income = Mortgage Value – FMV Collateral = Income

Gain = FMV Collateral – Adjusted Basis = Capital Loss

*Tax Policy:*

Depreciation allows for tax-free return of investment over time

Must treat equivalent transactions equivalently.

1. A sells \$1.2M house w/ \$1M mortgage to B for \$1.2M cash
    - A pays off mortgage, transfers property, realizes \$1.2M
  2. A sells \$1.2M house w/ \$1M mortgage to B for \$200k and transfers mortgage
    - A transfers property and B assumes mortgage, A realizes \$1.2M
- Under both transactions, A has the same enrichment. If his basis on the house were \$700k, his gain will be \$500k in both scenarios

Tufts court should have unscrambled the scrambled transaction.

- The sale of the property that had lost income resulted in both a capital loss, but there was also a forgiveness of indebtedness. The transactions should have been treated separately as O’Connor did in her concurrence.