Tax Outline

I. Scope of Federal Income Tax

A. §1: For Individuals
- §1(c): "There is hereby imposed on the taxable income of every individual…"
  - "There is hereby imposed" creates a legal obligation, "of" denotes ownership.
  - i. Every individual must pay;
  - ii. There is a legal obligation;
  - iii. The legal obligation is on the owner of the income.
  - Who is the "owner" of the income when the parents open a joint savings account with their child, who is 14? If the kid doesn't even know about the account, and the benefit will be going to the parents, the parents would seem to be the beneficial owner, so they would be liable for the tax. The Code cares about "beneficial ownership."
- There are statutory limits to shifting income to people in lower tax brackets. For example:
  - i. The Kiddie Tax: §1(g)(1)(a)
  - The Kiddie Tax is an alternate tax formulation for the income of children who are younger than 14.
  - ii.

B. The Policy of the Graduated Scheme
- The income tax system is progressive, based on a graduated scheme. Thus, you will never be hurt by making more money.

1. Rejected Theories of Taxation
- Congress has never adopted proportionality as the standard of fairness in taxation. With proportionality, the proportion of tax you pay always stays the same.
- Benefit taxation is understood to be just and the most economically efficient way to tax. However, we don't have a benefit tax scheme.
  - Problem with benefit taxation: In order to be able to impose taxes on the benefit, you have to determine who is getting the benefit.
    - i.e. Gas taxes pay for highways and roads, not defense. This is the benefit principle at work. It is an easy benefit to apportion. But what about general services, like defense. You'd have to accept that income is indicative of how much better people live from the benefit of US government services. This is a hard proposition to accept. For example, a lot of income tax goes toward poverty services, which do not really benefit high income taxpayers. Thus, at the federal level, it's generally agreed that what's going on is not benefit taxation. At the local level, there is more evidence of such benefit taxation, it's easier to see.
- Regression: The amount of taxes may increase with increased income, but it's a smaller and smaller share. An example of this is a retail sales tax. Congress had also rejected this notion.

2. Progressive Taxation:
- The share of income paid in taxes is increased with a rise in income.
- What is the philosophical basis for a progressive tax system? Why is progressivism better than proportionality? Does one's attachment to income decline as he makes more money?
- Congress' primary justification is the "ability to pay" principle.
  - This is a valid point, but does it justify progression? Why not have a degressive system: exempt lower income tax payers from paying taxes and keep the same proportion for everyone else?
- The progressive tax scheme is based on the assumption that the utility of each dollar for the taxpayer decreases as you make more.
- A higher rate of taxation on higher income earners does have the potential to deter longer work hours. For example, if X can make an additional $2,000 (which will push him into the next bracket) by working overtime, he might not want to do it because his leisure time is worth more to him than the amount he will take home after being taxed on the $2,000 at a higher rate.
- Under the progressive scheme, the current tax rates run from 10% through 35%. The top rate of 35% is historically very low.

3. Furtherance of Policies:

i. Horizontal Equity: Treating people in similar circumstances similarly.

- The progressive system does seem to reflect the principle of horizontal equity: Two people who make the same taxable income will pay the same income tax. Query, however, whether taxable income is an appropriate measure…

ii. Vertical Equity: Treating people in different circumstances with appropriate differences.

- Congress' view is that people with more income should pay a larger share of the tax – the proportion of tax they pay will increase. This is progression.
- The message of §1 in terms of Congress' view of fairness is:
  - i. Everyone should be forced to contribute involuntarily;
  - The amount exacted involuntarily will always cause pain. But, from the utilitarian viewpoint, it is less painful to give when you have more.
  - ii. Those with more money will have to pay more in taxes.
  - As your income goes up, you're required to pay more. A higher proportion of tax is forced on you are your income goes up.

iii. Economic Neutrality: Economically equivalent transactions must be taxed the same. (<u>Old Colony</u>)

D. Corporate Income Tax: §11

- §11(a): "A tax is hereby imposed for each taxable year on the taxable income of every corporation."
  - "A tax is hereby imposed" creates a legal obligation "on every corporation." This is the corporate tax.

1. What is a corporation?

- §7701 is one of the definitional sections of the code. §7701(a)(3): "The term 'corporation' includes associations, joint-stock companies, and insurance companies." None of the terms in the definition is defined. So Congress stops with ordinary usage.
  - §7701(a)(3) does not give an exhaustive list, there may be others, as indicated by the word "includes" rather than "means."
  - Congress used vague language to be sure to include ideas that might not normally be included. If they had said "business organizations" you would assumed profit making business organizations organized under state law would be included.
  - What is an "association" under §7701(a)(3)? Congress meant a voluntary business association unincorporated under state law.
    - Many profit making businesses are not an association, join stock or insurance company, yet they will still pay taxes.
    - Congress left out the obvious, but used language to encompass unincorporated business associations.

2. What about Cities and Municipalities?

- U City, for example, is incorporated under state law and is recognized as a collective organization under state law.
- U City is a corporation under §11 and is subject to an income tax, however, certain types of income are not tax. §115 gives on specific exclusion: "Gross income does not include: (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof…"
  - Thus, income from public utilities, or from the exercise of any essential governmental function is excluded.
    - Public Utility, under plain meaning, would be electric, gas, water, sewer, etc. What is an essential government function?
    - The IRS would generally take a very narrow view of what "essential" means. However, interest from a temporary savings account holding excess city funds has been long ago deemed to be an essential government function. Wise money management is an "essential government function."
      - In making this decision, the IRS recognized that they would be taking away the raises of underpaid policemen and fireman, etc.
    - If U City elected a socialist regime that takes over the bank, the bank could be considered a public utility. But the IRS would make a straight forward common usage argument, saying that a bank isn't a public utility. U City would argue that the tax would interfere with municipal government. U City citizens, by electing a socialist government, were saying that running the bank, for example, is an essential government function.
  - This ambiguity is probably intended by Congress, or maybe they just messed up.
- Generally, in resolving ambiguities in common usage, the court will look to:
  - i. Legislative history;
  - ii. Policy and purpose.

- §115 takes a policy view that taxes imposed by the federal government should not interfere with local and municipal government.

E. Basic Gross Income: §61

- §61(a): "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including, but not limited to, the following items…"
    - §61(a)(7): Dividends. This includes, for example:
        i. Dividends paid from a domestic company paid to a US citizen and resident;
        ii. Dividends paid from a French Company to a US citizen and resident. §61 says "from whatever source derived" so this seems to include dividends from a French corporation.
        iii. Dividends paid from a French company to a US citizen residing in England. Under §1, TP is an individual with §61 income "form whatever source."
        iv. Dividends from a French corporation to a French citizen residing in the US. Looking only at §1 and §61, TP must pay taxes. US residents, even if they aren't citizens, would seem to have to pay tax.
            - §2(d) limits the scope of §§1 and 61, however, the only special rule is for nonresident aliens, everyone else pays tax.
                - Under §2(d): "In the case of a nonresident alien individual, the taxes imposed by §§1 and 55 shall not apply only as provided by §§871 or 877."
        v. Dividends from a US corporation to a French citizen and resident in some instances.
            i) TP is a nonresident alien, so §2(d) applies. §871 imposes a tax on certain nonresident aliens. A 30% tax is levied on the amount received: §871(a)(1)(A):
                a. From sources within the US by a nonresident alien; and
                b. As interest… dividends, rents, salaries, wages… fixed or determinable (periodical income requirement); and
                c. Only if the amount is not effectively connected with the conduct of a trade or business within the US.
            - We know the income isn't effectively connected to a US trade or business (see ii). We know it's from periodical type income: dividends.
            - Is it from sources within the US? §861.
                - Dividends from a domestic corporation are expressly included in §861(2)(A): "from a domestic corporation." Under §7701(a)(4) a domestic corporation is one organized in the US or under the law of the US or of any State. Here we had a US corporation.
            - So, TP will pay the 30% flat tax on gross income from dividends. GM will take out the taxes, TP never even sees it. §1441 imposes on the payor of the dividends the obligation to withhold the 30% tax.

            ii) §871 also imposes a tax on certain nonresident aliens who: §871(b)
                a. Are engaged in trade or business within the US;
                b. Will be taxed as in §1 provided that income is effectively connected with the conduct of a trade or business within the US.
            - Under this §871(a) scheme the question is whether the dividends are effectively connected with a US trade or business. What is "effectively connected with a US trade or business?"
                - §864(b) says: "The term trade or business within the US includes…" Generally if you work in the US, you're engaged in a trade or business in the US, but the statute uses the term "includes," indicating it might be broader than Congress actually wrote it to be.
                    - Here, TP is merely receiving dividend checks. It seems that Congress is requiring some sort of "activity" in order to be "effectively connected…" Under §864 then, trading in stocks in not equivalent to being engaged in a trade or business activity.
                - So TP's dividend income is not the result of conduct of a trade or business.
            - §864(c) addresses the "effectively connected" requirement. Here TP's income isn't effectively connected because it's not the result of conduct of a trade or busienss.

            - So the general rule of §871:
                - If the income is effectively connected to a trade or business within the US, it is taxed at the §1 graduated rate. §871(b);
                - If it's not effectively connected, and you meet all of the requirement of §871(a)(1)(A), you will pay a tax of 30%;

- If it's not effectively connected, and you don't meet all of the requirements of §871(a)(1)(A), you will not pay taxes, as allowed by §2.
- So for International Taxation, there are three possibilities: Nonresident aliens are subject to US tax in some instances:
  a. Income "effectively connected" with US trade or business (for all intents and purposes, this means actually engaged in business within the US): §1 progressive tax on taxable income: §871(b).
  b. Income not "effectively connected" with US trade or business;
     and from sources within the US,
     and periodical type income; then
     30% flat tax on the amount received from sources within the US: §871(a)(1)
  c. Income not effectively connected with a US trade or business:
     Income not from US sources; or
     Income from US sources but not of a periodic type
     No tax: §2(d).

vi. Dividends from a Panamanian corporation to a French resident and citizen.
- Here the income is not effectively connected. The main question is if the dividends are from a source within the US.
- Since this is a Panamanian corporation, it's not a domestic corporation. But §861(a)(2)(B) has more restrictions:
  - Dividends from some foreign corporations are subject to US tax;
  - If more than 25% of the corporation's income is effectively connected with the conduct of a trade or business in the US.
- So it matters where the Panamanian corporation derives its income. This law prevents companies from incorporating abroad to prevent their taxation.

F. Tax Jurisdiction:
- 3 Sources of Jurisdiction:
1) Citizenship: Progressive tax on worldwide taxable income.
2) Residence: Progressive tax on worldwide taxable income.
3) Source: Active conduct of a business in the US or passive investment income from US sources, then you're still subject to tax.
- Residents may not be actual members of the US, but they're still gaining benefit from living here. People who pay based on the source of the income are benefiting from the US economy.
- What about citizens who reside abroad, work for foreign companies. By what virtue do they pay tax? They can always come back. This is a very attenuated connection.
  - The US is one of only 2 or 3 countries that imposes tax on the basis of citizenship alone.
  - By virtue of the tax based on citizenship, there looms the possibility of triple tax. Tax treaties sort out the claims for taxation by different countries.
  - The US grants a foreign tax credit in certain circumstances. The US, if jurisdiction is based on citizenship or residency, will ensure that the country with source jurisdiction will have first cut.
- Under §877(b) nonresident aliens are occasionally subject to tax under §1 when TP loses citizenship in the US in the previous 10 years in order to reduce his tax liabilities.
  - §877 is necessary to prevent enormously wealthy people from moving to countries with lower tax rates and renouncing citizenship to get the 30% flat tax rather than the 35% top US tax rate.
  - There's a presumption by the Code that if you come out better off, you did it to avoid taxes.

II. Overview of Tax Computation
A. What is taxable income?
- Taxable income reflects net income – gain or enrichment less the costs of earning it.
1. Gross Receipts vs. Gross Income:
- Gross Receipts are anything of value that you've received.
- Gross income reflects gain or enrichment.
  - By gross income Congress means to get at enrichment or gain, any increase in the TP's resources.
    - Loan proceeds, for example, aren't counted as gross income because you have to pay them back.
  - You're only taxed to the extent you recognize a gain.
2. Deductions
a. Generally
- Deductions are allowed out of fairness concerns: All gross income doesn't necessarily reflect a gain.

- 2 motivations for granting deductions:
    i. Reflect the cost of producing income;
    ii. Incent certain activities.
    - For example, if you earn $150/hour as a self-employed attorney, but you then pay your secretary, Westlaw, rent, etc., you only take home $50. So the costs of producing income are deductible, because they aren't an increase in wealth, no gain.
- Congress also uses deductions to incent people to act in a certain way.
    - For example, to save for retirement, make charitable contributions, etc.

b. Monetary Value of a Deduction:

- A $1 deduction reduces the taxable income by $1.
- A $1 deduction reduces your tax burden by whatever your highest personal tax rate is, i.e. 33 cents, 15 cents, etc. It depends on what your highest rate is.
- Itemized vs. Non-Itemized Deductions:
    - Both are subtractions.
    - It doesn't really matter that they're itemized and non-itemized are separated except for the standard deduction. However, in a non-itemized deduction, every dollar reduces the tax you will pay. You can ALWAYS get the actual amount expended with non-itemized. With itemized, it's subject to you not taking the standard deduction.
        - The standard deduction is an alternative to the itemized deductions. Taxpayers take whatever is greater in order to minimize their tax burden.
        - The standard deduction is usually set at a level to encourage 60% of taxpayers to not itemize. Those in the top 40% are usually those who are home-owners with property taxes and mortgage interest to deduct.

c. Deduction vs. Exclusion

- Exclusions always save you whatever your highest tax rate is. It is functionally equivalent to a non-itemized deduction.
- Some deductions, namely, itemized deductions when you take the standard deduction, won't save you any money.
- Why did Congress draw the deduction/exclusion distinction?
    - In general, a deduction refers to an expenditure of funds.
    - Exclusions, traditionally, have referred to certain receipts, certain money coming in.
    - From a functional view, things that are excluded from income do not appear at all. Deductions, however, must be shown on a tax return.

d. Deduction vs. Credit

- For credits, a $1 credit equals $1 of tax savings. For this reason, credits are much more valuable than deductions.
- As far as the Treasury is concerned, deductions and credits result in about the same revenue loss, so they don't care.
- Certain types of taxpayers prefer credits over deductions. Here's why:
    - The value of your deduction is dependent on your highest tax rate. A credit is independent of the tax rate. Thus, higher tax rate taxpayers prefer deductions; put differently, taxpayers with a rate greater than the % of the credit prefer deductions. Higher income taxpayers prefer deductions.
    - Lower income taxpayers prefer credits.
- Charitable Contributions, for example. Charitable contributions are an itemized deduction. With this, Congress is implicitly preferring higher income taxpayers. Lower income tax payers who take the standard deduction don't even get the benefit of a deductions. Charities want whatever favors their donors, churches get support from both low and high income earners, and therefore prefer a credit.
- Universities, for example, get their support from high income earners traditionally, so they favor a deduction.
- Congress is implicitly preferring the types of contributions made by higher earners. This may be the policy judgment behind this.

B. Random Notes on Deductions for Tax Paid to Foreign Jurisdictions:

- Under §164(a) Congress does grant a deduction for taxes paid to foreign jurisdictions.
- §901 is the foreign tax credit.
- Example:

TP's Profit:	$100	
	Tax Rates:	Tax Paid
France (source):	30%	$30
UK (resident):	42%	(100-30).42

US (citizen): 50% (100-30-UK Tax).50

- The amount of tax paid is much larger than the burden would be if you just did the transaction in one country. It's like 80%. So the US grants a 100% tax credit for taxes paid to foreign governments provided they are taxed on income.

So: France gets $30.
UK gets .42(100) = 42 – 30credit = $12.
US gets .50(100) = 50- 42 credit = $8.

- The combined effective tax rate is the highest country's tax rate.

III. Cash vs. Kind

A. Old Colony Trust: Economic Neutrality

- Economically similar transactions must be taxed the same. But always check to make sure the transactions are economically equivalent.
- In Old Colony, the company paid the executives tax obligation directly to the IRS. This one-step transaction is economically similar to the two step transaction where the company pays the employee additional compensation and the employee then pays the tax to the IRS.
- In Old Colony, if TP had received extra compensation, his tax liability would be legally enforceable, so he would have had to have paid the money to the IRS, he couldn't have just used it for whatever he wanted. If he could have used the money for whatever he wanted, then the two transactions would not have been economically equivalent.
- 3 arguments used by TP:
    i. To say that this was not income because of the common usage meaning of receipt, and he never received the money, leads to absurd and bizarre results. The court quickly dismissed it.
    ii. TP tries to say it was a gift. The court says no way, the term gift is not defined by common usage.
    iii. Tax upon a Tax argument could have been argued but was not presented. If it was used:
        - Everyone pays tax on a tax. The employer withholds money for tax from your income, but you then report the full amount of what you actually receive and what's withheld on line 1 of the 1040.
        - This tax upon a tax does not create an infinite liability, it does end.
        - But, should tax payments be included in taxable income? Tax income measures your ability to pay, your net enrichment for the year at issue. It is a quantitative measure of your increase in resources available for consumption or savings.
            - So if this is the case, what should be the result of tax withheld? If you make $3.3million but only get to keep $1million, why do we treat you as if you have $3.3million to consume or save, when you really never even see that money?
            - In principle, we should grant a deduction for involuntary disenrichment. For example, §165 state and local income taxes are allowed as a deduction because you can't use that money for your benefit. §275, however, does not give a deduction for federal income taxes or social security taxes. Why not?
                - If they allowed this deduction, revenues would fall and we'd have to raise taxes so that a higher rate would apply in order to make up the difference in revenue. Both approaches would reach the same result. It would end up with a tax rate of like 125%, which would lead to popular unrest, although this is the theoretically correct approach.

B. Meals and Lodging In Kind:

1. Benaglia Generally

- Benaglia received free room and board, as well as a salary, in return for his services as manager of two hotels. Was this taxable income in kind? He was always on duty.
- Meals or lodging served for the "convenience of the employer." The convenience of the employer doctrine requires business necessity: "solely because TP could not otherwise properly perform the services required of him."
    - Convenience, under Benaglia, means "absolutely essential."
    - If it's absolutely essential for you to do your job, maybe it's an incidental benefit and it is free.
- Majority holds that if the presence of Benaglia on the premises was critical to the employer, then it's incidental to him and he should not be taxed.
- Maybe this is a story of constrained consumption. TP did not have the privilege of choosing where to live and eat.
- Dissent: The dissent argued that Benaglia negotiated the terms of his employment contract. Since it was a bargained for term, it was intended as compensation and TP is getting a substantial value. Moreover, he only lived at one of the two hotels he managed, so it couldn't have been that essential. The dissent argues that "convenience of the employer" standard looks to the employer, when really we should be looking to the

employee, trying to measure his income. Benaglia is enriched because he didn't have to buy his own food or pay a mortgage.

2. Measuring Income in Kind: Plausible Alternatives:

a. Tax TP on the Retail Value (assume $7800, this was IRS's position in Benaglia): It's clearly too much to charge someone the full retail value. The TP would argue that it is not fair to compare him with someone who has $7800 in cash salary, as he wouldn't spend the $7800 on rooms and food at the hotel. Constrained consumption makes this unfair.

b. Tax TP on the Subjective Value (Assume $4600): This is hard to calculate – how will you even know the subjective value? The practical problem of ascertaining the subjective value makes this option unusable. However, in principle, this is probably the best approach.

c. Tax TP on the Cost of Other Arrangements – Expenses Avoided Theory (Assume $3600): In practical reality, this is probably the best choice. It's the administrative option that is closest to the second option. §119 and Benaglia do not use this approach though.

d. Tax TP on the Cost of the Employer (assume less than $3600 due to excess capacity) This one is wrong in principle and hard to calculate. Why is this even relevant? We're trying to measure the benefit to the employee, so in principle this is the incorrect approach. However, one could argue the expenses avoided is close enough to the benefit of the employer.

e. Tax TP on Nothing – Convenience of the Employee Approach (this is what Benaglia ad §119 use).

3. Compare:

i) TP1 has a salary of $10,000;

ii) TP2 has a salary of $13,600;

iii) Benaglia receives food and lodging worth $3,600.

- Which is most like Benaglia? TP2 has $10,000 left after providing food and lodging, as in Benaglia.
- If you tax TP1 like Benaglia, you get fairness and economic neutrality concerns. By virtue of the tax free nature of meals and lodging, you might be more likely to choose an industry that provides meals and lodging, rather than one that pays a comparable amount more but that you must pay taxes on.
  - If more people move to the hospitality industry for the free room and board, then there will be less demand, lower salaries, the employer will have lower costs, hotel corporations will pay more dividends. In the long run, though, you draw more competition which leads you to lower your prices. Reduced prices incline more people to eat out or stay in hotels, which leads to increased investments in hospitality and less investments in other industries.
  - So the tax advantage would result in a change in the way people spend their income. There will be a misallocation of overall wealth.
  - These are fairness and economic neutrality concerns. You want market prices to determine how people spend their money, not tax treatment.

4. §119

a. Kowalski Case

- NJ policemen were given an allowance for meals consumed while on duty. Policemen were required to eat meals in their patrol area while they were on duty. They had to eat in their patrol area, but could go to a restaurant, go home (if it was in their patrol area) or bring their lunch. The money was given regardless of what they did with it. The court found that this was taxable income under §119.
- The meal allowance is gross income under §61 because it is a gain and enrichment. It is "accession to wealth over which the TP has complete dominion."
  - Accession = increase
  - Complete Dominion = TP can use it however he wants.
- This case occurred post-§119, so Benaglia was not longer available. §119 was enacted as an exception/exclusion to §61.
- §119 does not apply here because this is a meal allowance – cash, not a meal in kind. §119 applies only to exclude the value of meals and lodging in kind.
- Moreover, even if Benaglia did survive, there was no business necessity here. Yes they have to eat to properly perform their duties, but the cash payment not essential for them to properly perform their duties. They can buy their own lunch or pay for it themselves. The only thing necessary is that they are able to each within a reasonable distance from their patrol area, but doesn't everyone have to do that anyway?

b. Sibla v. Commissioner

- Firemen worker 24 shifts. They weren't permitted to leave the station while on duty, and were required to participate in an organized mess at the station house, unless officially excused. They were provided a kitchen but had to buy and make their own meals. The firemen wanted to deduct the cost of the meals as a business expense under §162, arguing had would have been excludable under §119. The court held that yes they were deductible under §162, but not excludible under §119.
- The city had a problem with firefighters leaving their post for meals. So the city said you had to eat your meals in the firehouse, and provided appliances for cooking. The cook is paid by the city. The city imposed the requirements that they eat in the firehouse. In substance, is the city furnishing meals?
- §119(b)(3) does not apply because the employees were furnishing the meals, not the employers, and because the charge wasn't necessarily fixed. It depended on what the men wanted to eat. They did periodically pay in to the mess though.
- The court found this to be a business expense under §162, even though it looked personal, because the mess was involuntary, the firemen had limited ability to participate, and the employer did not compensate them for it.
- The dissent said that there was no constrained consumption here, the men could eat whatever they wanted, except that is had to be in the firehouse.

c. §119 Generally
- §119 requires the convenience of the employer, which is defined as business necessity.
- §119(a) is a very fact specific test – did this individual employee really need to receive meals?
    - If most employees are in that situation, you can give it to all employees under §119(b)(4) and the IRS won't make a issue of it. An employee by employee determination would be too costly. If the majority is eligible, you can give it to all. This was a concession to the hospitality industry, particularly in Vegas, that lobbied it in.

A. Lodging: 3 Requirements:
    i) Convenience of the employer – Business necessity (otherwise this would conflict with req. iii)
    ii) On the business premises – Place of employment of the employee, job location of the employee. Treas. Reg. §1.119(c)(1).
    iii) As a condition of employment – "Required… in order to enable him to properly perform duties of his employment." Treas. Reg. §1.119-1(b).

B. Meals: 2 Requirements:
    i) Convenience of the employer – Means convenient or helpful – "furnished for a substantial noncompensatory business reason of the employer." Treas. Reg. §1.119-1(a)(1).
    ii) On the business premises – Place of employment of the employee, job location of employee. Treas. Reg. §1.119-1(c)(1).

- Under §119, Benaglia's free meals and lodging would still be tax free.
- Examples:
    - X is paid $10,000 in stated wages, but $1,000 is withheld as payment for meals furnished by the employer on the business premises for the convenience of the employer. What is the tax treatment? After Kowalski, this would be a meal allowance and it would be nonexcludable. However, under §119(b)(3) Congress gives X a break and allows him to exclude the $1,000. This promotes economic neutrality and horizontal equity.
    - X is paid $9,000 in stated wages, and is furnished free meals worth $1,000 by the employer on business premises for the convenience of the employer. This is tax free under §119(a)(1).
    - Must a university president who receives an official, furnished residence, free of charge pay tax? Probably not under §119(a). The president would argue that it is on the business premises, it is a condition of his employment that he stay there, and it is a business necessity. He needs the residence to host fund raisers and entertain guests. Business necessity is an inherently factual determination.
    - Bush would not have to pay tax on the value of the White House. He does state dinners, entertains foreign dignitaries, etc. The on-call aspect of lodging is really not a good argument anymore because there are phones, etc. now.
    - Wiedenbeck gets a home one Forest Park Parkway from the university. §119(d)(1) would apply, but §119(d)(2) imposes a stringent limit on the value of the exclusion. He would have to pay tax on a significant amount. §119(d) is in the Code because universities in expensive areas often give housing to faculty and staff.

5. §107

- §107: "In the case of a minister of the gospel, gross income does not include – (1) the rental value of a home furnished to him as part of his compensation; or (2) the rental allowance paid as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances, such as a garage, plus the cost of utilities."
  - Minister of the gospel means all religions, otherwise it would violate the establishment clause.
- §107 has no business necessity requirement. Why the difference from §119?
  - §107 goes back to 1920 – it's probably a historical anomaly and that's why there's no convenience of the employer test. Congress probably never amended §107 because of the potential political fallout – you have an appealing group of people – ministers – in a unique position to complain about it. Once you have a special tax privilege, it's extraordinarily hard to take it away.
- Example: TP, a minister, if furnished with a home next door to the parish church. Is the rental value included in TP's income?
  - Under §107 this seems to be fine, it would excludable. Under §119(a) there would be the question of business necessity, it would depend on the facts.
- Example: TP, a minister, gets a rental allowance of $12,000 which he uses to rent a small farm. The parish serves a rural community and TP uses the farmhouse as her residence. Is there any amount includible in TP's gross income? See Treas. Reg. §1.107-1(c).
  - The statutory term at issue here is whether the farmland would count as a "home." To the extent you're renting the farmland and not the house, that's to provide business facilities and not a home. So that is not excludable. However, the house, yard, garden, garage and furniture are all part of the home, as well as the utilities, so rental for this would be excludable. Under §107(2) there's no cash vs. kind distinction.
- Example: TP gets a rental allowance of $18,000 per year, to allow her to pay off her mortgage more rapidly. What is the tax treatment here?
  - This is a §107(2) question since we're talking about cash. To the extent you're buying the home, you're paying for future years as well as the present year. When Congress says "rent or provide a home" did it implicitly mean this year? The IRS has always held that allowances to buy for future years is going to far. Congress means this year. You can't exceed the fair rental value of this year.
- TP, while continuing his job as an electrician, establishes the Universal Laugh Church and becomes its first minister. Thereafter, TP contributes half of his $50,000 salary to the Church and claims a charitable contribution deduction therefor. The Universal Laugh Church, in turn, pays its minister a $25,000 parsonage allowance, which TP uses to pay off the mortgage and for home repair, furniture and the like. What's the deal?
  - This arrangement allows TP to continue to make money as an electrician while getting free housing from his "church." Unless he performs actual duties and services as a minister of the gospel, it would seem to be quite objectionable. TP is trying to be taxed on $25,000 and deduct as charitable contributions $25,000. Then he gets the $25,000 back as a parsonage allowance which would be excluded. Under §170(c)(2) the deduction wouldn't be allowed. The televangelists with their big homes aren't being taxed on their rental allowances because of §107.

6. Tax Treatment of Good Received in Kind Not from Employer (Turner)

a. Rule:

Rule:	Nontransferable Goods and Services:	Expenses Avoided
	Transferable Goods and Services:	Net Fair Market Value (FMV – Cost of Sales)

b. Turner Case

- Turner won two steamship cruise tickets. He reported as income $520, but the IRS wanted him to report the retail price of the tickets, $2,200. The court comes up with $1400, about the average of the two.
- What's the right measurement of income?
  - §119 does not apply because there was no employer, this was a prize.
  - Retail price, in principle, is wrong because this is constrained consumption. Turner, at his income, wouldn't have spent an extra $2,200 in cash on the vacation. He would have maybe taken a better vacation, but not have spent so much. He didn't have free choice, so we shouldn't treat him as someone who would have spent his money on this.
    - Now, if the IRS could show that Turner and his family took a vacation on a cruise steamer to South America every year, then the retail price would be the right number. But this wasn't his pattern of consumption.
  - Expenses Avoided? He's better off because he doesn't have to pay for two weeks of food, as it's provided on board. Presumably he's not better off based on lodging since he's still paying for his house. Utilities

will be saved, as well as what he traditionally spent on his family's vacation. In calculating the expenses avoided, you're getting a minimum objective value of enrichment.

- Resale value: The tickets here were nontransferable, but what if they had been transferable? Then maybe tax the resale value of the tickets rather than the expenses avoided.
  - Resale Price = Net Fair Market Value.
  - Net Fair Market Value = Resale Value – Cost of Sales
    - Trying to resell the tickets, he wouldn't get the retail price of $2,200. To sell them he would also incur expenses, and reduce the price. What if he doesn't want to resell them?
      - If he could resell, but doesn't, then we know his subject value is more than the net FMV. So what to do? Tax him on the pleasure of the trip? But this is too subjective. So we fall back on net fair market value.
      - However, if you don't have an actual sale, it seems like it would be hard to assess the fair market value. Nowadays you could look on ebay though and subtract the cost of listing.

c. Haverly Case

- Haverly received unsolicited free text books as a sample from publishers. He later donated them to charity and took a deduction for the value of the books. However, he had never reported the value of the books in his gross income. The court held that you could not take a tax deduction unless you had reported the value.
  - Congress believes that charitable deductions should wipe out the prior income inclusion. It was money you had for your own enrichment and consumption that you gave away and can no longer use.
- In principle, free samples are re-salable, so the correct standard would be to tax him on the net fair market value. Once he received them, he could do whatever he wanted with them.
- Haverly took a $400 deduction, but he donated 12 5th grade social studies textbooks. They were hardly worth $400 to him, and what we care about is his enrichment, not the publishers'. The amount of Haverly's enrichment if he had tried to resell the books would be much less than $400.
- The FMV is more like $30. He should have claimed $30 for his net FMV – not the publishers' fair market value.
- If Haverly had kept the books he should report them as income, in principle. However, in practice you don't give it away and try to take a deduction. Congress has held that you don't have to report it on income because it is de minimis.
  - If Congress tried to enforce this – the reporting of free samples as income – they would piss everyone off. So the IRS has recognized the political realities.

IV. Fringe Benefits

A. §132

- §132 deals with fringe benefits: "Gross income shall not include any fringe benefit which qualifies as a: (1) no additional cost service; (2) qualified employee discount; (3) working condition fringe; (4) de minimis fringe; (5) qualified transportation fringe; (6) qualified moving expense reimbursement; or (7) qualified retirement planning services."
  - Under §132, (1) no additional cost services; and (2) qualified employee discounts, have line of business limitations.
  - Discrimination Clause: §132(j)(1) applies to employer discounts and no additional cost services. It imposes a non-discrimination requirement. Under §132(j)(1) the employee discount scheme can't favor highly compensated employees. §132(j)(1) applies to employer discounts and no additional cost services. It imposes a non-discrimination requirement. Under §132(j)(1) the employee discount scheme can't favor highly compensated employees, the discount must be available "on substantially the same terms to each member of a group of employees."
    - In determining what discriminatory means, Congress fell back on the definition it used for pension plans. In the pension context, relative percentage coverage is what's important. The coverage rate for the highly compensated employees must be less than or equal to the coverage rate for the lower compensated employees. If this is not the case, it's discriminatory.
    - The IRS looks for "operational discrimination." The Operational Test looks to:
      a. The amount of the benefit;
      b. Coverage (eligibility).
    - Discrimination clauses apply only to the high income earners, the lower compensated employees will not be taxed.
    - Non-Discrimination Policy: Don't want this to be hidden tax free compensation for the highly compensated employees. It allows a company to promote their products and get their employees to use the products and become more familiar with them if you do it right and fairly.

    - The government doesn't want to participate in inequality. If companies want to pay their executives more, that's fine. But Congress doesn't want the perception that the tax system is unfair. Otherwise people get made and don't comply.
    - In addition, nondiscrimination is a covert method of redistribution. It gives the employers incentive to pay the employees more so they will take the benefit. This gets more widespread utilization of benefit.
  - If something is deductible as a legitimate business expense, it is also an excludable fringe benefit.
- §1.132-5(n): Product Testing Standards: Must Meet All 6 Requirements:
  1) Testing is an ordinary business expense of the employer;
  2) Business reasons necessitate employee testing off-premises;
  3) Item furnished to the employee for purposes of testing;
  4) Made available no longer than necessary and returned to employer;
  5) Employer imposes significant limitations on employee use that significantly reduces the value of the personal benefit to the employee; and
  6) Employee must submit detailed reports on testing.

B. Examples

- TP is VP for design and product planning of Ford. Each month, TP is provided with a new Ford for both business and personal use. Each month a different model is chosen by the Company and provided to him. TP is required to submit a detailed record of his own and his family's evaluation of each model based on a minimum of 100 miles driven. Is the personal use income to TP?
  - Here it's the same as if Ford is paying him more money and then he rents the car himself, or if Ford pays less and provides the cars that are necessary to do the job. This is just Old Colony. The problem is that the VP is getting personal use from the cars as well. This is mixed business and personal use. Under §162, in cases of mixed use, you generally take an all or nothing approach. If it's more business than personal, it's all deducted. If it's more personal, none is deducted.
  - Here, however, the committee reports on 1132 go into detail on this situation and say that in this case, TP is getting a working condition fringe. So, there's a regulation on this: §1.132-5(n) but it's not in our books. In this case, TP will have met all 6 requirements. Although, number 5 is debatable.
  - If this didn't qualify as a working condition fringe, how much is income? You could use the net fair market value – the amount TP could get if he sold it to a willing buyer less the cost of sales, but this doesn't appear to be a transferable item for him. You could use the Expenses Avoided rule for nontransferable items. In that case the value would be not paying maintenance, cost of owning his own car, etc. Since this is nontransferable, it's not worth the FMV to the TP.
    - Congress has ruled that ineligible fringe benefits are taxed at FMV. See text at pg. 68.
- TP is an associate with a large NY law firm. In order to encourage its associates to put in the time necessary to produce high quality legal work, the firm follows a policy of reimbursing its associates for the cost of a restaurant meal (not exceeding$50) and a taxi fare home on any day on which the associate works past 8pm. TP arrives at the office about 10:30am and works until 8pm four or five nights a week. What are the tax consequences?
  - The supper money and cab fare is relieving TP of costs he would otherwise bear himself. So the question is whether this qualifies under §162. Cost of service and qualified employee benefits are out because of the line of business requirement. §262 says no deductions for personal living or family expenses. The only plausible §162 fringe is the de minimis. This is not de minimis. He will have to pay taxes. This rule is often not complied with by firms, but it should be added to wages and withheld on. §1.132-6 gives info on how to determine if something is de minimis.
    - De minimis: So low valued that its accounting is unreasonable or administratively impractical. The statute requires that you take into account the frequency of the fringe. But frequency of whom? How much TP uses or how much all associates use it? Or how much the entire workforce of the company uses it?
    - §1.132-6(b) follows the statute but tries to look more carefully at each individual employee. In a lawfirm, all of this supper money and cab fare gets charged to the client, so the employer's own conduct undercuts the argument that it's too hard to track.
- Deuce Hardware allows employees to buy its merchandise at a discount of 5% multiplied by the number of years the employee has worked for Deuce, but not exceeding 60%. Deuce is a local place with only 5 employees: a president who has worked for 10 years and 4 low-paid retail clerks, whose length of service varies from 1-4 years. The gross profit percentage on all of Deuce's merchandise is about 15%. How much of the discount is tax free to the president and retail clerks?

  - Under §132, if the president buys a $100 item, he will pay $50 but have to report $35 as income, as the gross profit % is 15%. If the clerk who has been there one year buys a $100 item, she'll pay $90 and not have to report anything in taxable income.
  - §132(j)(1) applies to employer discounts and no additional cost services. It imposes a non-discrimination requirement. Under §132(j)(1) the employee discount scheme can't favor highly compensated employees, the discount must be available "on substantially the same terms to each member of a group of employees." Who is a highly compensated employee? Look for a statutory definition. It is in §132(j)(6) – you're highly compensated if you satisfy §414(q)(1) if you:
    (1) Are a 5% owner at any time this year or last; or
    (2) For the preceding year received excess of $80,000 in compensation.
    So if the president is highly compensated, then there's discrimination. The president would have to pay tax on all of the discount. If there are "substantially the same terms for each member of a group… that does not discriminate." Arguably, this discount is available on exactly the same terms to every employee, but in practice, it comes out to be discriminatory. It does, however, appear to be neutral on its face, but the IRS always looks behind the documents – they look for operational discrimination.
- Deuce Hardware gives a 20% across the board discount for those with four or more years of service? That would be discriminatory in coverage. Is this a reasonable classification? To be a reasonable classification you need a business purpose. Under the pension plan discrimination definition, this plan is still discriminatory.

VI. Imputed Income:

A. Generally:

- Imputed income results from the investment of capital or performance of services for one's own personal or family use.
- Bartering is subject to the regulations in §1.61-1(a), -2(d)(1). Basically, if you want something tax free, you have to do it yourself.
  - When there is an exchange of services outside the household, it will be considered a market transaction and will be taxed.
  - If you exchange services within the household, i.e. wife cleans the kitchen, husband cleans the bathroom, or between roommates, etc., it's not taxable.
  - Even when you exchange identical services, §1.61-2(d)(1), it's still taxable if the exchange occurs outside the home. This is probably for the sake of a bright line rule.
  - Take carpooling, the value of services of someone driving you should be taxable income in principle, but the IRS does not tax in practice. Why? Maybe because no one would report it. Maybe there would be no way to figure this out without prying into people's privacy; maybe we don't want to tax honesty.

1. Examples:

- TP1 and TP2 each have $200,000 in savings, and each is in the 30% tax bracket. TP1 invests her $200,000 in a house which she uses as a residence for herself and her family. Because the house is well-built and located in a desirable neighborhood, TP1 expects to be able to sell the house for $200,000 at the end of 20 years. TP2 invests her $200,000 savings in corporate bonds that pay interest at the rate of 10%, with principal repayment in 20 years. TP2 uses the $20,000 annual interest to rent a house.
  - This is a cash vs. kind, Old Colony Trust problem. Congress taxes TP2 on the $20,000 annual interest, leaving her with $14,000 per year rent a house. TP1, however, is not taxed on the imputed rental value on her home. Homeowner is getting income in kind – she invested her money in the house and the "return" is living there. TP2 invested her money in bonds and gets a return in cash that he is taxed on. Then he still have to rent a house.
    - Congress is favoring the homeowner over the renter. This is a horizontal equity problem. To equalize the tax treatment, you either have to allow the renters to deduct what they pay, or tax the homeowner on imputed rental income. People will be dissatisfied with either alternative. It's hard to value imputed rental income. The current tax treatment leads to urban sprawl.
  - Here there is also an economic neutrality problem. The current tax scheme incents people to buy the house because there is no imputed rental income to the homeowner. However, if we allow TP2 a deduction, this will also lead to non-neutrality because more investment dollars will go to housing investments rather than innovation.
  - The only way to make it neutral and accomplish economic objectivity is to tax both. However, this presents the problem that people might not have the income stream to pay the imputed rental income tax burden. For example, if you retire and are on a fixed income, you might not be able to afford a large imputed tax if you own a big house.

- TP3 and TP4 are each in the 50% tax bracket, and each is married, works at the same job, and has two pre-school age kids. TP3's spouse works at home caring for the kids, doing housework, shopping, etc. TP4's spouse works at home, but has just been offered a job that would pay a $30,000 annual salary. TP4, however, has calculated that it would cost $18,000 annually for childcare and domestic services to replace their lost household services.
  - In order for it to be worth it for TP4 to work outside the house, she will need to make over $36,000. Thus, this system almost incents people to stay home if the market won't pay high enough to cover tax and household expenses.
  - You can either allow TP4 to deduct her household expenses, or tax TP3 on the imputed income from her household services. The problem is how to figure out the value of the household services. For example, how good of a cook is she? How clean was the house? How good of a teacher was she? Different values for different areas, different households, etc. Valuation is too difficult. The other problem is how much to let TP4 deduct for replacement services? In order to remedy this problem, Congress originally imposed a child care deduction. This allowed a deduction for qualified child care expenses. This deduction became a credit around 1970 when the rates of tax in §1 were quite high. The deduction was unfairly favoring high income tax payers, so it became a credit that gradually phases out. §21.
  - By not being able to deduct replacement services, Congress is causing many people to opt out of the workforce because it won't be worth it financially – i.e. they won't actually be able to make a profit. People will be dissatisfied with the imputed income alternative and valuation assumptions, i.e. my cooking isn't that good, and my house isn't that clean.
- TP agrees with his neighbor that he will mow both of their equal sized lawns every second seek. TP's neighbor will cut the grass on alternate weeks. Last summer, TP paid $1000 to have his lawn mowed every week. What are the tax consequences?
  - When you mow your lawn in week 1, it's tax free. When you mow your neighbor's lawn in week 1, you didn't get anything. In week two, however, you are getting paid in kind when the neighbor mows your lawn. This in kind payment is taxable. So after the summer is over, you end up with $500 in taxable income. The neighbors are also getting value from being off duty every other week.

VII. Tax Treatment of Damages

A. Third Party Payment of Liability: Clark

1. General Rule: 3rd party payment of a liability is enrichment, but if the 3rd party caused the liability, it's not taxable enrichment.
2. Clark Case:

- Clark hired an attorney to do his taxes who messed it up. Had the lawyer not messed it up, Clark would have not have to pay roughly $19k. So he sued his lawyer and got a judgment for the $19k. The court held that this was not income, as long as Clark had not taken a deduction for the loss in a prior year.
- The rule from Clark is that 3rd party payment of a liability is enrichment, but if the third party caused the liability, it's not taxable enrichment.
- Compare Clark with the TP who does his own return and makes a mistake. TP has no one to blame, he will not get restitution from a lawyer. Thus, there is vertical inequity. To solve this, you could tax Con the $19k or let the person who did his own taxes deduct his $19k mistake. A third way would be to allow deductions for all tax payments, and tax all refunds. This would take care of the Clark/TP equity problem.

B. Damages that Compensate for Lost Profits: Raytheon

1. General Rule: Damages that compensate for lost profits are income.
   General Rule: Damages that compensate for injury to good will represent a non-taxable return of capital to the extent of the cost basis in the good will. (Maybe taxed as capital gain).
   General Rule: In assessing whether the damages award is to compensate for lost profits or is for injury/destruction to good will, ask: In lieu of what were the damages awarded?

- The damages for injuries to good will are at least partly taxable income. Good will is an established business reputation that comes from an established set of customers. With good will you will have higher profits than a comparable new business. Good will includes trade names, trademarks, customer lists, business locations, etc. The value of the good will is the premium paid for the established business (excess over FMV of tangible assets and identifiable intangibles). Sometimes a business owner can sell its good will. For example, you could sell a grocery store for the price of the real estate, inventory, equipment, etc., and also the name of the business and a noncompete agreement.

2. Raytheon Case:

- An antitrust case. RCA drove Raytheon out of business. RCA invented a competitor vaccuum tube which required radio manufacturers to use only the RCA tubes. So Raytheon went down the tubes. Raytheon filed an antitrust suit and won a judgment of $40k in damages, $60k in payment for license fees for Raytheon's patents, and $350K in damages for the antitrust violation. RCA also sued Raytheon for nonpayment of patent royalties, so no money actually changed hands, but there was still value received so it was taxable in kind. Raytheon treated their judgment as damages, not taxable income. But the court disagreed.
  - The damages are lost profits. But for RCA's interference, Raytheon would have had these profits. RCA is forced to disgorge these profits. This is Old Colony Trust.
  - The damages for injuries to good will are at least partly taxable income. Here, Raytheon lost the value of their trade name. Had RCA voluntarily bought the business, Raytheon would have gotten money for their good will. Here, Raytheon is getting damages for the total destruction of its business. So the measure of damages would be the FMV of the business, which includes the good will.
  - If you wreck someone's car and are forced to pay them the FMV, how much will be income? It's a forced sale, so the proceeds would be taxed just like a voluntary sale. To the extent you get more from the sale than what you bought it for, you are taxed. §61(a)(3); §1001(a): Amount Realized – Adjusted Basis = Gain. So in the same vein, damages aren't taxable to the extent the cost of the property exceeds the amount realized. You're not enriched to the extent you're getting back your investment, the cost of the property sold. Involuntary transactions should be taxed the same as voluntary transactions. The court concludes this is compensation for the destruction of good will and taxes all $350k. Why? Because Raytheon failed to prove that it's cost basis in the company was more than $0. This was self-constructed good will, they didn't purchase it from anyone else. If they had bought the good will, they would've been able to prove their basis.
  - Here, Raytheon lost the whole business, not just some sales. If they had only lost some sales, the distinction would have been murkier. The court looked to the what the parties were arguing about to determine whether it was destruction of goodwill or lost profits. Look to the best available evidence of a factual basis of the legal claim. Can also look to the jury verdict.

3. Examples

- Damages for breach of an employment contract. For example, assume that a college football coach is fired with 3 years left on his contract. Yes taxable. In lieu of wages the damages were awarded. They're a substitute for wages that are taxable in full.
- Damages for wrongful destruction of property. Suppose that a building burns down as a result of a tenant's negligence, and the landlord recovers $300,000. What is the proper tax treatment of the recovery? Assume that L's adjusted basis in the building at the time of fire was $200,000. Yes taxable to some extent. In lieu of sales proceeds from a voluntary sale the damages were awarded. This was wrongful destruction of property. There was a forced sale of the building. A forced sale is taxed as a voluntary sale. Amount realized – cost. Here he is taxed on $100,000.
- Malpractice damages in Clark. Not taxable. In lieu of after-tax savings the damages were awarded. The damages were substituting the $19k that Clark would have had in his pocket after paying taxes. So we shouldn't tax it. It's a replacement of after tax income, so the money substitute has to be treated in the same way.
- Compensation for breach of promise to marry. The justification for damages is the wedding costs, emotional distress, loss of consortium, etc. The damages for the costs of the wedding would be tax free, because this is a replacement of after-tax dollars. The damages for emotional distress would also be tax free, because the psychological well-being you would have had but for the breach would have been tax free imputed income. Same with loss of consortium.
- Damages for loss of an arm in an auto accident caused by a drunk driver. Medical expenses are a replacement of after-tax income, so under Raytheon, it's tax free (Clark 3rd party payment of liabilities also)(also tax free under §104). Lost wages are a replacement of past and future wages, so that would be taxed. It's possible the victim will get a large lump sum, since it's future and past earnings, that will push him into a higher bracket, but those are the breaks. (Under §104 this is not taxable). Pain and suffering is imputed income so it's tax free. We wouldn't have taxed you on your well-being. (also tax free under §104). Punitive damages don't work under the Raytheon replacement rule. They are compensating society, not the victim, although the victim usually gets the money. This is compensation imposed as a deterrence for the benefit of society, it's a windfall and windfalls get taxed. (§104 does not address punitive damages, Glenshaw does and under Glenshaw they're taxable).

4. §104(a)

- §104 provides express statutory exclusions for personal, physical injuries only. Raytheon is still the standard for determining if something is income.
- §104(a)(2) states that gross income does not include "the amount of any damages (other than punitive damages) received… on account of personal physical injuries or physical sickness."
- §104 applies only to physical injuries or sickness, emotional distress does not count.
    - ***If you get a judgment based on emotional distress (i.e. pain and suffering, medical expenses, etc.) there's no express statutory exclusion, so you go to Raytheon and figure out what is taxed and what is not… OR… are they saying that it's all taxable since Raytheon is unadministrable?
- So under §104, those large awards for lost wages would not be taxable. Why? When the jury comes back, there's a lump sum that is unallocated. Hard to figure out how much of the money goes to what. Damages for pain and suffering and loss of future earnings are very subjective.
    - To remedy this problem, you'd need special verdicts and ask the jury to sort it out. Legislators won't be happy having to requires state courts to use special verdicts. It violates the federalism principles. The alternative is to have the federal system work it out, basically try the case again. But this judicial inefficiency is undesirable.
- So §104(a) is a concession to reality. Even though some of it ought to be taxed, we can't sort it out, so it either has to be all taxable or all tax free. They went for tax free. Why? Then you're not trying to tax income that isn't in the meaning of income within the constitution. Also by making it all tax free they aren't further beating up on innocent victims. It promotes respect for the tax code and serves political purposes.
- §104 was adopted very early on. By granting an exclusion for all of this, §104 also does away with the concern of taxing a lump sum of money years of future income at a higher tax rate all in one year. Instead they don't tax any of it. Wiedenbeck is very skeptical of this.
- Why did Congress stop where it did? §104 exempts all damages other than punitive damages. But you still have to sort out the amount of punitive damages because they are taxable. So does that undercut the policy reasons for §104? Not really. Pretty much everyone today (all states) use special damage forms for punitives, so they are sorted out.

C. Punitive Damages: Glenshaw Glass

1. General Rule: Punitive Damages are taxable.
2. Glenshaw Glass Case

- Glenshaw won a judgment against another company for damages for fraud and treble damages for injury to the business by reason of antitrust violations. There was $325k in punitive damages awarded. The court said itw as taxable income.
    - Congress measures gross income as "gains for profits and income derived from any source whatever." This language is used by Congress to exert the full measure of its taxing power. Congress applied no limitations as to the source of taxable receipts, and the Court has given liberal construction to this broad phrasing to tax all gains except those specifically exempted. Punitive damages are no where specifically exempted.
    - The full measure of Congress' taxing power is the power given by the Constitution in the 16th Amendment. Income should be understood as broadly as the constitution allows under the 16th Amendment.
    - Punitive damages are a windfall, clear enrichment. There is undeniable accession to wealth, clearly realized, over which Glenshaw has complete dominion.
- *** So income is:
    a. Gain, enrichment, accession to wealth;
    b. Clearly realized;
    c. Over which the taxpayer has complete dominion. (Maybe this prong should be a factor as to the amount of income, not in the determination of whether there is income.)

D. Annual Accounting: Sanford and Brooks

1. General Rule: Taxable income shall be computed on the basis of the taxpayer's taxable year. §441(a).

2. Sanford and Brooks Case

- Sanford entered into a contract with Atlantic Dredging to carryout a government contract. They tried to perform under the under the contract but were unable because of a breach of warranty of the character of the material to be dredged. They suffered operating losses during the year of attempted dredging in 1913. In 1916, Sanford sued the US. In 1920, Sanford received $176K in an award. The court held that this was taxable income for the year 1920.
- There are three kinds of losses:
    a. Operating Losses (the kind of Sanford) §172: Where income is less than the costs of producing the income (negative profit)

b. Loss on Sale/Disposition of Property: Where proceeds are less than the cost of the property (negative gain)
c. Casualty Loss: Where there is sudden damage or destruction to the property (negative windfall).

- The loss at issue here was an operating loss. The net enrichment did not exceed the cost of producing income. To the extent you have negative enrichment, you generally get a loss deduction.
- Sanford had a net operating loss from 1913-1915. They deducted all costs as ordinary business expenses under §162. Now that they have gotten a judgment for the fees they should have gotten, they don't pay tax. The IRS argues these are additional fees that should be taxed as gross income. Sanford is upset because if the fees were received in the earlier years, they would have been gross income, and with their costs, it would have worked out to $0 income. But when the deducted $176 in the earlier years, it didn't offset any income, so the deductions did no good. They're arguing that they're paying tax on the receipt side of a no profit transaction when they didn't get the benefit of loss deductions simply because of the delay.
- The court says pay the tax. You have to pay tax on the receipt side of a no profit transaction simply because it was received in a different year than the costs of performance were born. As authority, the court said this result was compelled because Congress said so.
  - §441(a): Taxable income shall be computed on the basis of the tax payer's taxable year.
  - This language is very clear. It went to the Supreme Court because they were testing its constitutionality. Under the 16^{th} amendment, Congress was granted the power to tax income. The purpose of the 16^{th} amendment is to allow Congress to raise revenue. Annual accounting is part of this. Without the 16^{th} amendment, Congress could only have taxed labor income, not income from property. So the 16^{th} Amendment was enacted to create fairness, to raise revenue fairly. Prior to the amendment, Congress imposed an annual tax. Amendments should may be interpreted with a view to what the 16^{th} Amendment ratifiers though.
  - Court says maybe this is unfair, but it's constitutional. The result if the tax policy goal was fairness in the apportionment of the tax burden is Sanford wouldn't have been taxed. The Supreme Court was probably worried about fixing the inequity as a matter of constitutional law. They didn't want to constitutionalize every tax problem.
- Under Raytheon, these damages were received in lieu of increased contract fees, so they would have been gross income and taxable.

3. §172

- §172 defines net operating loss. §172(a) allows a deduction for net operating loss carry backs and carry forwards. If this has happened post-enactment of §172:
  - In 1920 you have to report the $176K as income under §441(a), but to the extent you have excess losses in earlier years, you can carry them forward and deduct them in 1920. §172(a).
  - The function of §172(a) is to ameliorate the unfairness of that taxable year income provision - §441(a).
  - §172 was the response to Sanford.
- At the time of Sanford, Congress had already enacted §172, but it didn't apply retroactively.

E. Tax Benefit Theory

1. General Rule:

Inclusionary Side:	If the prior error resulted in deductions that lowered the tax burden, the **recovery** must be included in gross income.
Exclusionary Side:	If the prior error was harmless, the prior deductions didn't help you, then the **recovery** is treated as a tax free return of capital. The rule revolves around the original deductions.

2. Dobson Case

- In Dobson TP bought 300 shares of Citibank stock in 1929 for about $1,000 per share. In 1930, TP sold 100 shares at a $42,000 loss. In 1931 TP sold another 100 shares at a $28,000 loss. In 1939 TP received a settlement of $45,000 for the fraud claim he made.
- Under Raytheon, in lieu of after-tax income he received a refund of his purchase price of the stock. So under Raytheon this wouldn't be taxable. The $45k was damages that he received. Because of the fraud, he paid an excessive purchase price. It was a tax-free return of capital.
- The issue is how to compute gains/loss on the later sale? If he paid $1000 per share and received $150 per share in settlement, then…?
  - Some portion of the $45K recovery is apportioned to the shares retained. He paid $1000 when he originally bought the shares, but he's already received $150 back tax free. So this must be reflected in computing future gains and losses.
  - So it will be: Cost Paid per Share: $1000 – Refund: $150 = Adjusted Cost Basis of $850 per share.
  - If he then sells them for $980 per share – Adjusted Cost of $850 per share = $130 gain per share.

- This result is also compelled by §1001. Under §1001:
  - Amount Realized: Total sales proceeds whether received in cash or in kind.
  - Adjusted Basis: Basis (defined in §1012) +/- adjustments provided in §1016.
  - Basis of Property: Cost, the after tax investment.
  - Adjustment to Basis: Proper adjustment for property shall be made for receipts properly chargeable to the capital account. (This means a tax free return of capital). The receipts are singled out because it's relevant to Dobson.
- So under §1001, if you own a house worth $180k, and you then put $40k into an addition, your adjusted basis would be $220k. An upward adjustment from your original basis of $180k.

- So for TP in Dobson, what about the tax treatment of the 200 shares sold in 1930 and 1931?
  - §1001(a) loss is the excess of adjusted basis over the amount realized.
  - §165(a), (c)(2): You can deduct any losses generally that are not compensated for by insurance or otherwise. It is legislated permission to deduct losses.
    - §165(c): Lays out the deductions allowed for losses for individuals:
      (1) Losses incurred in a trade or business;
      (2) Losses incurred in any transaction entered into for profit, though not connected with a trade or business;
      (3) Except as provided in (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.
  - In this case §165(c)(2) is relevant.
  - Why the deduction for losses? The income tax is supposed to be fair. If your wealth goes down you have a reduced ability to pay. Income tax reflects enrichment, so disenrichment should be deductible, as it reduces your wealth and your ability to pay.
- So, assume TP's deduction for losses on the sales of stock in 1930 and 1931 offset income, then what do you do when he gets the recovery?
  - Under Raytheon you have a refund of the purchase price. This calls into question the loss deductions taken in 1930 and 1931. The deduction was justified as disenrichment, but not the money comes back to him in 1939. There is no problem with Raytheon, we just need to fix the prior deduction.
  - So we have to require him to include the recovery in income in order to offset the prior erroneous deduction. He claimed a deduction in 1930 of $42k. He recovered $150/share in 1939, so on 100 shares that is a $15k recovery. The proper deduction in 1930 would have been $27k. So in 1939 he is taxed on the $15k recovery. If you're in a higher bracket in 1939 than in 1930, too bad.
- This is the "inclusionary side" of the tax benefit rule. It's primarily an error correction device.
- What is the 1930 and 1931 adjustment did not offset other income? This was the case in Dobson. He had no income to offset. The prior deductions saved him nothing, the prior error in deducting was thus harmless, it didn't hurt the treasury.
  - If the error was harmless, the prior deduction didn't help you, then the recovery is treated as a tax free return of capital. This is the "exclusionary side" of the tax benefit rule. If there's harmless error, then don't apply the tax benefit rule, the inclusionary rule.
- The fundamental question revolves around the original deductions.

3. §111: Exclusionary Side of Tax Benefit Rule

a. Generally

- §111 is Dobson codified. It is the exclusionary side codified, because to have an exclusion, it must be codified.
- §111: if you don't get a benefit from a recovery, you don't have to include it.
- Recovery: Direct repayment of the amount you paid out earlier from the party you paid it to.
- §111 provides a very limited form of relief.

b. Dobson v. Sanford: The issue in applying §111 is what is a "recovery."

  - Sanford seems to mirror Dobson – They claimed a deduction, but didn't have the income to offset it so there was no loss to the treasury. Could Sanford have used §111?
  - The money awarded in Sanford was income, it was fees for performing the work. But is that a recovery?
  - There is no definition of recovery in the code. But, a recovery comes from the same people you paid the money to.
    - In Dobson, there's a direct refund of the amount he paid earlier from the person he paid it to.
    - In Sanford, is the money coming back from the same people he paid it to? No, the dredging company paid the suppliers, etc., but not the government. So this is NOT a recovery.
  - So no, §111 would not apply to Sanford. The prior deductions were for business expenses, and that never came back.

c. Tax Benefit Rule §111 vs. Complete Justice §172

- The inclusionary side is not a complete correction due to changes in the tax rate or the tax bracket that TP is in.
- §172 was Congress' response to the negative profit situation found in Sanford. But it doesn't address the Dobson situation. It is a Net Operating Loss Deduction statute.
  - Only excess deductions related to a trade or business are allowed. So they are looking only to the negative profit situation.
  - §172 isn't available to Dobson, as the loss was related to his investments, not a trade or business.
- §172 is the general form of relief for problems caused by the annual accounting requirement. Apply §172 first, to the extent it doesn't make you whole, and you have a valid recovery, then apply §111. Relief under §172 comes first. If you can't get relief and you qualify for relief under §111, then you take that.
- You can offset income under §172 for something like 20 years.

- What about amending earlier returns?
  - There's a statute of limitations for both the IRS (§6501) and TP(§6511). The Statute of Limitations is generally three years from filing the return.
  - If you don't file a return, you never even start the statute of limitations. If the taxpayer realizes he has made a mistake and overpaid, he has three years to amend the return and get his money back.
- In Dobson, there wasn't actually an error in his returns in 1930 or 1931, as taxable income shall be computed on the basis of the taxpayer's taxable year. §441(a). Since the returns were correct when filed, he didn't have the option to go back and amend.

VIII. Tax Treatment of Health Care Costs.

A. Generally

- 3 ways to finance health insurance:
  a. Employer Provided: Gross income under §61 if employer pays the premium, but the value of the premium is **excluded** under §106.
     - The proceeds of this are **excluded** by §105(b) and §213(d)(1)(2)(definition of medical care).
  b. Employee Purchased Coverage: The premium payments are medical care under §213. So you get a **deduction** to the extent the premium payments exceed 7.5% of AGI. This is provided by §213(d)(1)(D).
     - Proceeds are **excludable** under §104(a)(3).
  c. No Insurance/Costs Paid Out of Pocket: There are no premium payments.
     - Medical payments are deductible under §213(a). **Deductible** to the extent the medical expenses exceed 7.5% of AGI. But this deduction is also itemized, so in this case, the deductions aren't equivalent to the exclusions of employer provided coverage or employee purchased insurance.
- Best case is for the employer to provide your insurance. Then it's all excludable.
  - The second best alternative is to pay as you go. Option c.
- §105(g) defines employee and doesn't include sole proprietor or partner.
- §162(l) gives relief to the sole proprietors and partners and allows a deduction.

B. Policy:

- Message: There is no neutrality in the three ways of financing health care. Congress is trying to incent as many people as possible to get covered by their employers.
- Broadly available health insurance drive up demand, however. Because it's insured, people will get 2^{nd} and 3^{rd} opinions, etc. This may be driving up health care costs.
- There have been proposals to put an annual cap on the §106 exclusion, in order to reduce demand and encourage consumers to focus more on the societal costs that they're creating.
  - More coverages today require deductibles and copays. This makes the patient feel part of the cost and is therefore less likely to get silly services. Many employees also now pay part of the premium.
    - If the employee pays part of the premium, the scheme falls somewhere between option a and option c. It's a scrambled transaction. The premium withholding is essentially employee purchased insurance. The most you could do, however it to turn to the §213 deduction, but this won't get you very far since it has the 7.5% floor you must reach. So copays also usually won't be deductible because of §213(a). The proceeds, however, when you pay part of the premiums or make copays are still excludable.

C. Cafeteria Plans §125

- What is each employee gets to choose whether or not he wants a reduction in his take home pay of $1500 to pay to health insurance? Each individual is choosing if he wants it. If the employee decides to take the reduction and the insurance, he is essentially providing his own health care. So it would see to fall under option b.

- However §125 is the Cafeteria Plan statute that expressly excludes the $1500 from the employees gross income for qualified benefits. Qualified benefits are defined in §125(f).
- In this arrangement, if the employee chooses the coverage, the value is tax free. If the employee chooses to take home the $1500 cash, the cash is taxable.
  - This is a departure from the traditional substance over form of tax law. It's a tax incentive to choose the insurance.

D. Wage Replacement
- The Codes creates a different tax regime for those health-related expenses that do not satisfy the §213(d)(1)(A) definition of "medical care." For example, cosmetic surgery and replacement of wages or salary lost as a result of inability to work due to personal injury or sickness.
- Generally speaking, one end of the transaction or the other is subject to tax.

a. Employer Provided Coverage: Premiums are **excluded** from tax under §106.
  - Proceeds are **included** in gross income under §105(a), with a possible credit in §22.

b. Employee Purchased Coverage: Premiums are **not deductible** under §213(d)(1)(D).
  - Proceeds are **excluded** under §104(a)(3).

c. No Coverage/Pay as You Go: No premiums.
  - **No deduction** for expenses paid under §213(d)(1).

E. Examples and Cases:
- TP has $50,000 in AGI. He pays $5,000 in premiums for his individual insurance. 7.5% of his AGI is $3,750, so under §213(a) he can deduct $1,250.
- Ochs:
  - The guy tried to deduct the expenses of sending his two kids to boarding school as an extraordinary medical expense under §213. His wife had been sick with throat cancer and he was told by the doctor if he didn't get the kids out of her hair her cancer could come back. The majority held these were nondeductible family expenses.
  - Majority's Approach: Direct vs. Indirect Distinction: Was the expense incurred for a direct or indirect aid to the medical condition?
  - Dissent: The dissent sees Old Colony as direct authority that this is pure formalism. The dissent lists a few possible tests:
    (1) Was the expense incurred at the direction and suggestion of a physician?
    (2) But for? Did the treatment bear directly on the physical condition in question? (i.e. but for mom's illness, husband wouldn't have sent the kids to boarding school) (primary motivation – maybe this is what they're trying to get at).
    (3) Did the treatment bear such a direct or proximate therapeutic relation to the bodily condition as to justify a reasonable belief the same would be efficacious?
    (4) Custom or convention? (customarily you send your kids to boarding school to get an education, not to get rid of the kids). This seems to have the same result as the direct vs. indirect test.
    (5) Was the treatment in proximate time so near to the onset or recurrence of the disease or condition as to make one the trust occasion for the other, thus eliminating the expense incurred for general, as contrasted with some specific physical improvement?
  - In different contexts, courts/Congress adopt one or the other of these different approaches.

IX. Annuities:

A. Generally
- A term certain annuity lasts for a specific number of years.
- In a life annuity, the insurance company promises to pay you $X for life, annually. When you buy a life annuity, you are effectively buying life insurance and in part investing your money.
  - Life annuities are used to finance retirement, to ensure you don't exceed your savings.
  - Life annuities transfer the risk that you'll live too long to the insurance company.
- Most people don't buy straight life annuities. Joint life annuities are more common.
- The issue is when to tax TP on the amount he receives in excess of his capital contribution. There are five alternative tax schemes:
  i. **Return of Capital First**: Under this approach, the IRS holds that you aren't enriched until you've gotten back tax free everything you put in first. This is the ROC First rule. It is a very conservative and cautious approach.
    - The taxpayer gets the benefit first. This approach is most favorable to TP's.

- This approach is used in circumstances when it's unsure that TP has any gain, or have any gain in the future.
- Open Transaction Doctrine: If you can't tell at the time of the transaction if there will be any gain, we'll wait and see if you get any income and then tax you. This method is occasionally used today.

ii. **Return of Capital Last**: Under this approach, all the interest income is taxed first, and thereafter you get your tax free ROC. This is the opposite of option i.
- The IRS gets the benefit first.
- This method is used for sales of stock and other non-depreciable property, and for the proceeds from a sale of rental property. With rental property, the return of capital comes last, when you sell the property. (§1001)

iii. ****Pro-Rata Return of Capital**: Under this approach, a fixed portion of every payment is tax free.
- The way to figure this out is as follows: Yearly Payment x Capital/Total Annuity Payment = Pro Rata Return of Capital.
- This is what §72 uses to tax annuities. Congress chose this method.
- This is also called straight-line depreciation. You are using up an asset at an equal rate over time.

iv. **Back Load Return of Capital**: Under this approach, the annuity is treated like a mortgage.
- Assume 10% Interest Compounded Annually.
- Year 1: Loan Principle = $3,790; 10% Interest = $379; Principle = $621.
- Year 2: Loan Principle = $3169; 10% Interest = $317; Principle = $683.
- An so on, you would pay tax each year on the interest received.
- Many think this is the conceptually correct way to tax annuities, but front load return of capital is equally as valid.

v. **Front Load Return of Capital**: This is a derivative of the mortgage amortization scheme.
- This is used for accelerated depreciation, as well as endowment contract.
- In an endowment contract, you get a promise that the insurance company will pay you a fixed sum of money at a specified future date. A term certain annuity is functionally equivalent to separate endowment contracts.
- Insurance Company 1: What is the cost today to pay me $1,000 in one year? If there is 10% interest: $1000/1.1 = $909. ($909 + 10% interest = $1000) (taxed on the $91 in interest).
- Insurance Company 2: What is the cost today to pay me $1,000 is two years? If there is 10% interest: $1000/(1.1)^2 = $826 (Taxed on the $174 in interest).
- Insurance Company 3: What is the cost today to pay me $1,000 in three years? If there is 10% interest: $1000/(1.1)^3 = $751 (Taxed on the $249 in interest).

B. §72
- Congress has chosen the pro-rata return of capital approach to tax annuities.
- Under §72(a), the default is that every penny of an annuity received is taxable. But §72(b) gives an exclusion ration equal to: Investment in the Contract (as defined in §72(c))
  Expected Return (as defined in §72(c)(3))
  - Investment in the Contract, §72(c): Aggregate amount of premiums paid.
  - Expected Return, §72(c)(3): Depends of life expectancy, with reference to the actuarial tables at §1.72-9. The actuarial tables give the life expectancy. Use table V. So expected return is the average amount the annuitant of this age would get.
  - The exclusion ratio give you a percentage that you use then to calculate the tax-free return of capital for each year.
- If the annuitant dies before she lives out her life expectancy, then you turn to §72(b)(3).
  - The Unrecovered Investment in the Contract = Investment in the Contract – Amount Received that was excluded from gross income.
  - So you deduct the capital left from the annuitant's income for the year of her death.
- If the annuitant lives longer than her life expectancy, the payments each year become all gross income. The exclusion is limited to the investment. §72(b)(3). Once you've gotten back your tax free investment, the exclusion ratio shuts off.
  - Until 1986 you could continue to collect payments and use the exclusion ratio. Congress thought it was cruel to terminate the exclusion for outliving your expectancy. But they got over it and now you have to pay tax.

C. Annuity Tax Shelters
- Many annuity contracts allow the owner of the contract to borrow funds from the insurance company. Usually the taxation for these transactions isn't the same as if you take it as an annuity.
- §72(a) applies to "amounts received as an annuity.

- §72(e) applies to "amounts not received as an annuity."
  - Money Received On or After Annuity Start Date: Under §72(e)(A), the money received will all be taxed as income, no return of capital, if received on or after the annuity starting date.
  - Money Received Before Annuity Start Date: Under §72(e)(B), If distribution occurs prior to the annuity starting date, you get ROC Last, so it's treated as interest and included in gross income of the extent you've earned interest under the contract.
    - The Code reverts to ROC Last, rather than Pro-Rata, because it is eliminating a tax shelter. The §72(a), (b) method gives you tax deferral relative to other investment types.
    - Congress' first tax treatment of annuities was ROC First, so people were able to take interest out every year and use it as a tax free return of capital. This was a great tax deferral scheme.
    - In §72(e)(3) Congress went to a ROC Last scheme. Under §72(e)(6): Amount Paid in the Contract = Aggregate Premiums Paid – Capital Returned. Return of Capital Last effectively shuts down the tax shelter.
    - But, under §72(e)(5), ROC First is used when you cash in the contract and cancel the policy. You can also be grandfathered into ROC First in 172(e)(5)(B).

D. Examples:

1. TP buys a 5 year $1000 annuity (term certain annuity). TP gets five $1,000 checks over the next 5 years, with no bearing on whether he lives or dies. The insurance company charges a premium of 3,790.
   - Part of what TP is getting is what he paid out. He's really only enriched by $1210: $5000 - $3790 (ROC) = $1210 Gross Income. Essentially, TP is lending the insurance company money and the insurer is paying him $1210 as interest.
   - The issue is when to tax TP on the $1210. The question is one of timing. There are a number of plausible alternatives. In each alternative, the total taxed remains $1210. Under §72(c)(3)(B), Congress has chosen the pro-rata return of capital approach for tern certain annuities.
   - Here TP would get $758 each year in non-taxed return of capital and $242 each year in taxable interest.
2. TP buys an annuity that pays $5,000 per year for life. She paid $50,000 for the annuity when she bought it at age 70. She dies at age 84.
   - Under §72(a), the default is that every penny of an annuity received taxable. But §72(b) presents an exclusion ratio: <u>Investment in the Contract</u> (as defined in §72(c))
     Expected Return (as defined in §72(c)(3))
   - Investment in the Contract, as defined in §72(c), is the aggregate amount of premiums paid. So in this case her investment in the contract is $50,000.
   - Expected Return, as defined in §72(c)(3), depends on the life expectancy, with reference to the actuarial tables. Under table V, TP, aged 70, would be expected to live 16 years, so she would get 16 x $5000 = $80,000.
   - So her exclusion ratio is: <u>$50,000</u> = 62.5% So, $3,125 of each yearly payment would be tax free return of
     $80,000 capital, and $1,875 would be taxable interest.
     - 62.5% of the $5,000 is excluded from gross income, it's a tax free return of capital.
   - Now, what it TP doesn't live for 16 more years? What if she dies in 14 years at the age of 84? She hasn't gotten her entire investment yet. So you go to §72(b)(3). She can take a deduction for the amount of capital remaining from her final tax return.
3. TP buys a $5,000 straight-life annuity, commencing at age 70, when he is 45 years old, and he pays for it in installments (annual premiums) of $900 per year until the annuity starting date. How much of each annuity payment is subject to tax?
   - TP will pay $900 per year from ages 45-70, then she will receive $5,000 a year beginning at age 70.
   - Use §72(b): <u>Investment in the Contract</u>: <u>900 x 25</u> <u>$22,500</u> = 28.125% exclusion ratio.
     Expected Return 5000 x 16 $80,000
   - So, for each $5,000 payment: $1,406 is tax free return of capital; $3,794 is interest included in gross income.
   - The premiums paid here are much smaller. Consequently, you are taxed more. The insurance company has more time to invest it before they start paying you out.
   - You could have put your money in the bank, or bought treasury bonds, etc., in which case you would've paid tax each year on the interest.
     - In the annuity you get tax deferral on the interest received. So all else being equal, you'd rather loan your money to the insurance company for the tax deferral.

X. Life Insurance

A. Generally

1. Generally
- Term Life Insurance vs. All Other Types (whole life, universal life, etc.)
  - Term insurance is the only true life insurance. For a fixed term, X pays a premium. If X dies during the fixed term, X's beneficiaries will get the face value of the contract. At the end of the stated term, the policy has no value.
  - X can usually renew the policy at the end of the term, but the rates will usually go up. Premiums go up with age. Often X can buy a policy with guaranteed renewal. But once you hit 65 or 70 years old, you usually can't buy term insurance anymore at an affordable rate.
- Everything else (whole life, universal life, etc.) are term insurance policies plus a savings/investment component. It's a scrambled transaction of two different contracts put together.

2. §101
- §101(a): Amounts received under a life insurance contract, on account of the death of the insured, are not taxable.
  - §101(a) does not say "proceeds" of a life insurance contract. Nevertheless, all of the proceeds are excludable.
- If you cash out the life insurance policy before you die, the treatment is different. §101 does not apply. Rather, you look to §72(e)(5)(A), (E), and (e)(6).
- §101(g) was enacted in response to the AIDS crisis. If you are terminally or chronically ill, you can turn in your life insurance contract, cash it out, and the IRS will treat it as if you received it on account of death.
  - §101(g)(1) allows you to cash it in tax free to care for end of life care.
  - §101(g)(2): If you are on your death bed, and you can't cash it out because it's a term policy, you can sell the policy tax free. There is no need to calculate gain or loss under §1001. The proceeds of the sale are treated as if they were proceeds of the life insurance contract itself.

B. Tax Treatment of Life Insurance Premiums
1. Term Insurance
- If you're going to tax term life insurance premiums correctly, you'd have to know on an individual basis why each of the insureds bought the policy. This is subjective, very hard to determine.
  a. Example: Insured is a wage earner, dependents are the beneficiaries. Life insurance would be a wage replacement function. In this case, it seems like the proceeds should be gross income as a matter of theory.
     - The premiums paid are the cost of protection, like a cost of earning the income replacement. Under this theory, the premiums would be deductible.
  b. Example: Insured is a homemaker, the beneficiary is the wage earner. The policy seems to be taken out to protect against the loss of the homemaker services. Under Raytheon, the proceeds would not be taxed, as they are, in substance, a replacement for homemaker services – imputed income.
     - The premiums paid would not be deductible since the proceeds are tax free. The Cost of earning tax free income is not deductible.
  c. Example: Insured is a homemaker, but her beneficiary children are grown and out of the house. This is in effect a gift of inheritance. The proceeds, under §102(a) would not be taxable because they are a bequest.
     - The premiums could not be deductible since the proceeds are tax free.
  - Perhaps a bright line rule would be better. Overwhelmingly, life insurance is bought as wage replacement. As such, the proceeds would be taxable and the premiums deductible.
- §101(a): Gross income does not include proceeds under a life insurance policy. So Congress picked the opposite of what theoretically seemed correct.
- §264(a): There is no deduction for premiums paid on a life insurance policy.
  - Why did Congress do it this way? §101 is very old. It does have some advantages – there's no tax on grieving relatives. Under §101, you insure for less – insure for the present future value of your after tax earnings, rather than your pre-tax income.

2. Whole Life Insurance
  a. Example: TP, age 45, buys a $100k whole life insurance policy. The policy matures at age 65. TP pays premiums of $3500 per year for 20 years.
     - If you die before 65, your beneficiaries get the amount of the policy.
     - If you live to 65, you can take the value of the policy. It's now an investment that you can spend.
     - This policy is a scrambled transaction. Assume that $500 of it is the premium for decreasing term insurance, and $3000 of the premium is an investment deposit. So the next year, you would not have to buy $100k in insurance because you have the $3000 you deposited earlier with the interest return.

        - By the age of 65, the insurance company is just giving you back the value of your investment. The $500 per year premium bought decreasing term life insurance.
        - If paid out early on, almost all of the $100k would constitute an insurance payment. In the later years, the insurance payment is pretty much over.
    - Assume Insured dies 2 days before age 65. §101(a)(1).
        - Beneficiaries would get $100k. About all of the $100k is the balance of the savings account. Almost nothing is the insurance component.
            - $60k is the capital deposits
            - $40k is the interest income.
        - So you would treat it as $40k taxable if you were to do it the theoretically correct way. But under §101(a), gross income will not include any part of the $100k because they were paid by reason of death of the insured.
    b. Example: What if TP cashed out the policy 2 days after age 65?
        - §72(e)(5)(A): The amount shall be included in gross income but only the extent it exceeds investment in the contract.
        - Investment in the Contract, under §72(e)(6), is Aggregate Premiums Paid – Anything you Received Tax Free.
            - So $30,000 would be taxable as the interest, and the $70,000 would be nontaxable.
        - So you get tax deferral with this insurance contract and are undertaxed when you are taxed.

XI. Realization Requirement
A. Eisner v. Macomber
1. Case Facts:
- Macomber owned 2200 shares of Standard Oil. Standard decided to issue a 50% stock dividend. Standard sent Macomber 1100 additional shares of stock. Standard did this rather than give cash dividends, because they were showing their shareholders they were doing well. It was a public relations device. What's the appropriate tax treatment of the grant of additional shares? The majority holds that it is unconstitutional to tax these shares. The stock dividend is not income.

2. Alternatives for Disposition of Corporate Profits:
    i. Retain and invest in the business: Retain earnings for growth. Shareholders not taxed.
    ii. Retain, invest in the business, and issue stock dividends. Shareholders not taxed.
    iii. Issue optional stock or cash dividends. Shareholders taking the cash and the stock would be taxed.
    iv. Distribute to shareholders as a cash dividend: Shareholders are taxed.

3. Pitney Opinion
a. Major Premise: Income means gain derived from capital, labor, or both.
b. Minor Premise: Shareholder derive nothing from the corporation on receipt of a stock dividend.
- Ultimately concludes that a person receiving stock dividends isn't deriving income.
- In issuing these stock dividends, Standard's revenue did not change – they didn't reflect this "grant" on their financials.
- Macomber kept the same % ownership interest after the receipt of the stock dividend. It was just more paper representing the same unchanged ownership interest in the corporation. If a shareholder derives nothing, then there isn't income.
- The majority analogizes options i and ii above.
    - In both i and ii, Standard is retaining the earnings to reinvest in the business. ii is simply more paper representing the same interest in the business.
    - Since Congress has no power to tax i, it can't tax ii.
- The majority finds that a corporation and a partnership are different, rejecting the minority's view. The taxing of retained partnership profits and retained corporate profits is a difference of substance. The majority explicitly rejects the partnership analogy.
    - The partnership theory is rejected because the fundamental premise of partnership law is that it is a voluntary association. The partner can always disassociate himself from the partnership and be paid the value of his investment, and share in the profits. There is dissolution on demand. The partner can get his share simply by insisting on it.
        - If a partner is enriched because the firm had a good year, the partner can take his profit and get dissolution by withdrawing. Thus, even though a general partner didn't get the profits, he could have at any time by his right to dissolution.
    - A corporate shareholder, meanwhile, has no right to dissolution on demand.

- Shareholders have no right to withdraw, only a right to persist, subject to the risks of enterprise. A general partner can always get out of the firm. Shareholders can't force the company to pay out its assets to you for your share. Your only option is to try to sell the shares. Pitney thinks this is a fundamental, material difference.
- If we were to follow the partnership model with corporations, that might create practical difficulties. How can you tax the shareholders on the profit of the company if they aren't receiving the profits?
  - Some S corporations use the pass through type of tax scheme, but shareholders get distributions from the board to pay the tax burden.

4. Brandeis Dissent:
- Everyone agrees Standard could have taken any of the four alternatives above. Brandeis focuses on alternatives ii and iii.
  - If you give all the shareholders a choice, as in iii, everyone agrees this is taxable to every shareholders, even those that take the stock. Thus, there's really no difference between option ii and iii, especially if the company prices the shares such that most shareholders would choose the stock given the choice.
  - If option iii is taxable, ii, by analogy, should also be taxable.
- The problem with Brandeis' analogy is that the majority comes back with its own analogy between i and ii. Brandeis acknowledges that i and ii must be treated the same. He concedes that ii is more similar to i.
  - But, unlike the majority, Brandeis thinks that Congress has the ability to tax i, so it can also tax ii.
  - Brandeis says that the Court shouldn't restrain Congress' ability to tax these different alternatives. The only thing Congress must do is adopt a reasonable definition of income.
  - So he then says that Congress could tax shareholders on the increased value of the investment due to retained earnings. It's like taxing a partnership. A partner is taxed on his retained partnership interest. Thus, Congress can tax undistributed corporate profits to the shareholders.
  - Congress has always taxed retained partnership earnings, so they can also tax corporate retained earnings. It's merely a difference of form. The majority says this is a different of substance.

5. Implications of Macomber

a. Deferral or Forgiveness?
- Is this outright exclusion or just a deferral? It's a deferral. When the taxpayer sells, his gain will be taxed:
  - Original Investment = Cost $X = 2200 Shares
  - Stock Dividend = Cost $X – Tax Paid Saving = 3300 Shares
  - Taxpayer Sells = 3300 Shares: Presumably, the value of the shares has gone up since when she bought them. When Macomber sells the stock, she gets the sales proceeds. Her tax is then:
  - Tax: Sales Proceeds – Adjusted Basis. §1001
- So this is deferral only, a question of timing. Unrealized appreciation. §61(a)(3).
- An annuity is also a deferral of tax, as is life insurance. But here there is only a timing question.

b. What to do with Increased Property Value?
- These types of gains are far less realized than corporate profits. If Congress can't tax undistributed corporate profits, a fortiori, unrealized market appreciation is also not taxable.
- Mere appreciation in the value of property is not taxable.

c. Business Income Taxation:
  i. Classic Corporate Income Tax: §11 Corporate Income Tax
     §61(a)(7) Dividends are taxed.
     This is the double tax on corporate profits.
     - There is no deduction for the company for dividends paid. To eliminate the double tax, you could give corporations a deductions for dividends paid.
     - There is a debate on whether the double tax is sensible. It is discouraging investment?
     - In 2003, dividends are taxed at a lower rate, in §1(h)(3). They will be taxed as capital gains, reducing their tax rate.
  ii. Pass Through Business Taxation
     - You are only taxed on your earnings once.
     - §701 – partnerships are not subject to corporate income tax. Partnership profits are taxed directly to the partners.
     - §731(a)(1) – distributions of money or property to a partner are tax free. Contrast with corporations, where dividends are taxed.

6. Congressional Response to Macomber:

i. Realization in General

- §61(a)(3): "Gains derived from dealings in property." The derived from language, also from Pitney's opinion, implies that you need something other than your original investment.
- §1001(a): "Gains from the sale or other disposition…" There must be a realization event to trigger a gain that is taxed.
- Congress pretty much followed the Macomber opinion. Congress had to follow Pitney because this was a constitutional law issue.

ii. Stock Dividends:

- §305(a): Congress codified the result of Macomber. Stock dividends are tax free.
- §305(b): Exceptions:
  (b)(1): Distributions in lieu of cash – the optional stock dividend is taxable.
  (b)(2): If the stock dividend has the effect of changing the proportionate ownership of any shareholder, it's taxable for all shareholders.
  - Stock dividends must be a purely formal transaction to be tax free. That is, no change in ownership.
- §307(a): In non-taxable stock dividends, the basis of the new stock is determined by "allocating between the old stock and the new stock the adjusted basis of the old stock."
  - So: TP owns 4 shares, with a cost basis of $120 and a FMV or $150/share. TP gets a 50% stock dividend. Now he owns 6 shares with a basis of $80 per share. The FMV is now $100/share.
    - So if TP sold 3 shares after the stock dividend, he would have a taxable gain of $60. This would be the same gain as if he had sold ½ of his shares (2) before the stock dividend.

iii. Continuing Validity:

- Macomber's continuing validity as a matter of constitutional law is in doubt.
- The distinction that the partners have the power to dissolution on demand is becoming irrelevant because of the new limited partnerships, in which partners do not have the right to dissolution.
  - So now that the distinction is moot, maybe the Supreme Court would no longer stand by the constitutional basis of Macomber. Lower court holdings have found that.
- As a matter of constitutional law, the Supreme Court might not stand by Macomber today, but as a matter of tax policy, it's still probably the best way to go.

B. Realization Generally

1. Advantages of Realization:

- Macomber will be taxed when she sells the shares. She ultimately controls the timing of taxation.
  - If we don't wait for realization, the alternatives would be to tax when the corporation pays out dividends, or tax her every year on the company's undistributed profits.
- So TP gets maximum tax deferral.
- Any increase in your wealth is income, so if you dispense with the realization requirement, you will have to report any increase in the value of stock, land, etc. You would need annual year end appraisal of all assets.
  - This would be a massive undertaking. There would be lots of disputes and appeals as to the FMV.
- So a big advantage is that you don't have to appraise all the assets every year. The sale to an unrelated party fixes the valuation. Otherwise we would have a problem of administrability.
  - Although, would it really be impossible to value everything in a cost-justifying way? You could look up the year end value of publicly traded stocks. You could use the property tax value of your home, and the blue book value of your car.
  - The real problem would be the ownership interest in privately held companies. So there's really only a very limited reason for the realization requirement.
- Liquidity Concerns: Prospect of taxing increases in value when TP doesn't have any cash to pay the tax obligation. Pitney points out this problem in his opinion.

2. Disadvantages of Realization:

a. Problem of Horizontal Equity. Compare:

- TPA invests $1000 in stock of corporation A. A $100 profit is reinvested in the company, so TPA is not taxed.
- TPB invests $1000 in stock of corporation B. A $100 profit is paid as a cash dividend. TPB is taxed.
- B is taxed, A is not. If it's 10 years before A sells the stock, A has 10 years to play around with his $100 for as long as he chooses to hold onto company A stock.
- Maybe you can reason away by horizontal equity problem by saying, well, everyone has a choice.

b. Economic Neutrality Problem: Taxpayer C is likely to choose the corporation that doesn't distribute its profits.
   - The allocation of capital resources will be distorted.

c. Vertical Equity Problem:
   - More wealthy people will be inclined to buy company A. They're in a position where they don't need the money to live and can invest for the long haul.
   - In the real world, most people need a current return to feed their families.
   - Brandeis say this as a real problem with realization. This tax deferral opportunity is uniquely available to the highest income segment.

C. Helvering v. Bruun Case

1. Facts Generally

- In 1915 Bruun signs over a 99 year lease to a tenant. The tenant had the right to tear down the old building and put up a new building. In 1929, the tenant tears down the building and puts up a shiny new one. Tenant soon after defaults and the landlord takes over the property. He gets back the lot with a new building. So the question is do we tax the value of land in 1933 when the landlord received his land back? The landlord was supposed to get his land back in 2015, when the building would have no value. Landlord got something back he never expected to get. The Supreme Court says Bruun realized a gain, physical severance isn't required. Rather, the transaction must be complete.
   - Bruun argues that yes, he got a new building, but that the gain wasn't realized. There was no sale or exchange, all he did was get the land back. There was no severance, the building was still connected to the land.

2. Court's Rationale - Control

a. Court's Rationale

- Gain was realized in the sense that Bruun now had control over the accession to wealth. Macomber, conversely, did not – she was forced to let the company control her profits. He money was still subject to the control of the board.
- Once the tenant is gone, Bruun had complete control, he had severed his gain from the underlying risks of the transaction.
- The court held that "Economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from liability, or other profit realized from the completion of a transaction. The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative the realization."

b. Alternative Schemes for Tax Treatment of Lessee Improvements:
   i. Post Paid Rent – Landlord has income on termination of the lease, in an amount equal to the then-prevailing FMV of the building. This was the Court's choice in Bruun.
   ii. Pre Paid Rent – Landlord has income in the year the building is completed, in an amount equal to the predicted FMV of the building on lease termination, discounted to present value.
      - This option is not desirable. You pay tax up front, as soon as it is placed on the land, but it is hard to value.
   iii. Pro Rata Rent – Landlord has income each year from the time building is completed to the end of the lease term, in an annual amount equal to the predicted FMV of the building on lease termination, divided by the number of years remaining to lease termination.
      - This is the annuity approach.
   iv. No Rent Ever – The landlord has no income at any time during the lease transaction. This was the taxpayer's argument in Bruun.

- The main difference in all of these approaches is timing.
   - Even option iv, when Bruun sells the land and the building, he'll get $51k more than he would get for just the land, so his gain would be $51k, since he had no basis in the building. This is just tax deferral.
   - Eventually the landlord will do something with the building. If he were to later sell the building, he would have a huge gain because he had no basis.
- Assume landlord's cost in the land was $5k and he had no basis in the building. He sells the real estate in 1933 for $60k. The FMV of the land is $10k and the FMV of the building is $50k.
   - Under the Post Paid Rent approach he would have $50k in income in 1933 on forfeiture of the lease. When he sells later on for $60k, he would be taxed twice for the same gain. Double taxation on the same value

isn't the right outcome, so you have to let him increase his basis by the amount he was earlier taxed on. He would have \$0 gain on the building and \$5k gain on the land.
- The raising the basis rule is not supported in any of the regulations or in the Code. But the result has never been quested by the court.

3. Realization Rule:
- Rule: Have you severed your gain from the underlying risks of the transaction?
- Rule: Is the transaction complete?

4. Congress' Response:
- Congress responded to Bruun by enacting §109 and §1019.
  - §109: "Gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, presenting the value of such property attributable to buildings erected or other improvements made by the lessee.
    - §109 Congress says the Supreme Court was wrong. They codified Bruun's position. The "derived by " language in §109 says the income is realized. Congress says we have the power to tax him, but they grant an exclusion.
    - §109 covers situations where the landlord leases property for rent and also requires the tenant to build a building. So low cost rent with rent in kind for the building. Rent is rent, whether in cash or in kind, so it's taxed as gross income.
      - In Bruun, the lease was for 99 years and the building had a 99 year life, so it was not rent in kind.
      - If you "may" build a building that is a tougher case. If you are not obligated to build a building, but there's no economic use for the land without a building, as a matter of economics, you would have to build the building. Thus, substance over form, so this would be taxable rent in kind.
  - But §1019 is an associated basis rule. Always look for an associated basis rule when there is an exclusion, this will tell you whether you are getting tax forgiveness or tax deferral.
    - Once you claim an exclusion under §109, you have no increase in basis under §1019, so you only get tax deferral, not forgiveness. But maximum tax deferral is granted.
- Why did Congress do this? They didn't want to bankrupt the landlords. It was a response to the Great Depression. Landlords aren't likely to have the money necessary to pay the tax. This better aligns the timing of the tax with the ability to pay.

5. Examples
- Adjusted basis is always a running measure of your after tax investment in the property.
- What is Bruun leases the new building to new tenants?
  - i. All rent is gross income.
  - ii. If you tax him on the value of the improvement, his basis in the building goes up to \$50k (the value of the building). Over time, the building wears out. You need to allow a deduction for depreciation. The value of the property that wears out is a cost of running your business.
    - Depreciation = $\dfrac{\text{Adjusted Basis of the Property}}{\text{Expected Period of Use (Useful Life)}}$ $\dfrac{\$50{,}000}{\text{50 Years}}$ = \$1,000 per year deduction for 50 years.
    - Net Income = Rents – Depreciation Deduction
  - iii. If you don't tax Bruun on the value of the building when he gets the lease back, his adjusted basis will be \$0, and he'll get no future depreciation deductions. So his taxable income from rent will be higher.
    - You get maximum tax deferral if you don't pay taxes until you rent or sell the building, but eventually you catch up with him.

D. §1031 - Realization and Recognition Problems

a. §1031 gives tax deferral, not tax forgiveness.
- A Nonrecognition Exchange: No gain or loss shall be recognized on:
  - i. An exchange of property;
  - ii. Property must be held for productive use in a trade or business, or for investment;
  - iii. Must receive property of like kind;
    - General Rule: Like kind generally depends on the totality of the circumstances as to whether you have substantial similarity in the underlying nature of the risk or investment.
    - §1031(h)(1): Real property in the US is not of a like kind to real property outside the US.
    - §1.1031a-1(b): Basically says that land for land is like kind.
    - Realty for personalty never qualifies as like kind.

- §1.1031(a)-2 Safe Harbor: This is a new rule for depreciable, tangible personal property. If the property to be exchanged is in the same asset (same class for purposes of depreciation rules) or product class, they are like kind and you can get non-recognition.
  - If you don't fall into the same asset or product class, or aren't depreciable, you still might get non-recognition after applying the general substantial similarity rule.

iv. Like property must be held by the new owner for productive use in a trade or business, or for investment.

- §1031(a)(2) does list several exceptions that it does not apply to.

b. §1031(d) – Partial Like Kind Exchanges Gains

- §1031(b) applies to transactions that are part like kind and part not like kind. In this case, gain shall be recognized to the extent of any money received and the fair market value of the boot.
  - So §1031(d) gives partial tax deferral even where the exchange isn't solely in like kind.
  - Major changes in the nature of the investment are taxed. To the extent you withdraw from substantially similar investment, you are taxed.
  - If you have a gain with boot, you can be taxed on gain up to the extent of the FMV of the boot.
- In an exchange of property, unlike the usual cash sale, each party is both a purchaser and a seller. Because each party is terminating one investment and embarking upon another, each has a realized gain or loss on the property given up and must determine his basis in the property received.

c. §1031(c) – Partial Like Kind Losses

- Under §1031(c), in a partially like kind exchange with a loss, the loss is never recognized.
  - If you have a loss with boot, you can't deduct any of the losses.
- Taxpayers want to defer gain and recognize losses as soon as possible. Ultimately, the owner of the property has control of the disposition of his land, so he controls the timing of the gain or loss. If a taxpayer wants to take a loss immediately, he should just sell the property outright and take the loss which is deductible immediately.
- §1031(c) gives Congress a break over the taxpayer's complete control of timing.

d. Policy Behind §1031:

i. Liquidity Concern/Taxpayer Compliance: The liquidity issue. Want to make sure that the taxpayer can pay the tax. Convenience in timing will help to make this happen. This is a partial concern, but can't really explain all of §1031(i.e. why aren't stocks included?).

ii. Horizontal Equity/Fairness Concern: A swap for very similar property is really not that different from simply continuing to hold the property.

iii. Administrative Concerns: Avoid valuation whenever possible. Too hard to do.

iv. Economic Neutrality: Capital Lock In – This is Congress' core concern.
  - The requirement of similar property used to make a buck is in response to capital lock in and horizontal equity concerns.
  - If we dispensed with the realization requirement, we'd have no capital lock in problems.

1. TP1 wished to expand her restaurant. She arranged a swap with her neighbor, TP2. TP2 deeded the parcel of unimproved real estate adjoining the restaurant to TP1. TP2 had paid $30,000 for this land. In exchange, TP2 received a parcel of unimproved realty in another location that TP1 had purchased as an investment for $55,000. TP2 intended to use his new lot as a building site for his personal residence. The value of each parcel at the time of the exchange was $70,000.

   a. TP1 has a realized gain of $15,000: Amount Realized $70,000 – Adjusted Basis $55,000 = $15,000.
      - Amount realized = FMV of the Property Received + Money Received.

   b. TP1 has $0 recognized gain.
      - §1031(a)(1): "No gain or loss shall be recognized on:

        i. An exchange of property;

        ii. Property must be held for productive use in a trade or business, or for investment;

        iii. Must receive property of like kind;
        - §1031(h)(1): Real property in the US is not of a like kind to real property outside the US.
        - §1.1031a-1(b): Basically says that land for land is like kind.

        iv. Like property must be held by the new owner for productive use in a trade or business, or for investment.

- Here there is an exchange of property in satisfaction of i. TP1 gave up an empty lot that was bought as an investment, so that satisfies ii. The exchange was for property next to his restaurant to use as part of his restaurant, so that satisfies iv. The property was of a like kind in satisfaction of iii because is was land for land. Thus, TP1 has no recognized gain from this transaction.
- But §1001(c) says: "Except as provided, all recognized gain or loss is immediately recognized on sale or exchange of property." §1031 provides an exception.

c. TP1's basis for the adjoining lot is $55,000. This is also referred to as the "exchanged basis."
  - §1031(d): Basis of Property Received =
    Basis of Property given up – Cash received +/- Gain or Loss Recognized.
  - So here we have: $55,000 - $0 +/- $0 = $55,000.

- If TP1 were to sell lot 2 the day after exchanging it, TP1 would have a $15,000 realized and recognized gain.

d. TP2 realizes $40,000 in gain. ($70,000 - $30,000 basis)
  - TP2 recognizes $40,000 in gain. He will be taxed on this because he is using the land he got for his personal residence, so he failed to meet requirement iv.
  - TP2's basis in the new lot is $70,000: Basis of Property Given Up (30,000) – Cash Received (0) + Gain Recognized (40,000) = $70,000.

- All realized gain must be recognized unless there's an express statutory exclusion granted by Congress.
- Personal residences – owner occupied housing – is in part a scrambled transaction. True. In part you buy it to live there, in part you buy it in hopes it will appreciate and you'll make a buck when you sell it. But there is no objective means to sort out the parts, so Congress usually does all or nothing, and here it does nothing.
- If TP2 can't pay the tax, he'll have to take out a loan, or the IRS will sell some of his assets to get the cash. Congress wasn't willing to give all exchanges non-recognition.
- What if TP2 had originally planned to use the land for investment, but then changed his mind and built a house? He'll have the burden of proof to show this to the IRS. May be a difficult factual problem.

2. TP3 owns GM stock with a basis of $55,000 and a market value of $70,000. He trades the shares for GE stock which had cost TP4 $30,000. What result for each taxpayer? You assume that the FMV of the GE stock is $70,000 or else the exchange wouldn't have taken place. Even Exchange Hypothesis.
   a. Realization for TP3: $15k ($70,000 - $55,000)
      - Amount Realized = FMV of GE Stock + Money Received
   b. Realization for TP4: $40k ($70,000 - $30,000)
   c. Recognition for TP3: $15k; Recognition for TP4: $40,000
      - This is not a like kind exchange. §1031(a)(2)(B). So it must all be recognized immediately under §1001(a).
   - Why don't TP3 and TP4 get tax deferral?
      - **Vertical Equity**: Putting this deferral opportunity in the hands of the wealthy leads to vertical inequity. Non recognition for stock swaps would allow wealthy investors to never pay tax as long as they just swap stock.
        - Infinite tax deferral is essentially tax forgiveness and really only the wealthy would be able to take advantage.
      - In addition, partial ownership in a domestic car company and partial ownership in a multi-national conglomerate is not the same thing. The taxpayers have materially changed the underlying risks of their investment (Bruun). The underlying business and markets are different, but so are the boards.
        - Even if you were to exchange GM for Ford the underlying risks are still different.
3. TP exchanges a small apartment building that he had bought for $100,000 for a tract of unimproved real estate valued at $86,000, and $26,000 worth of construction equipment "to boot."
   a. TP realized $12,000 (Amount Realized = FMV of Land + Cash + FMV of Boot 112,000 – Basis 100,000).
   b. TP recognizes a gain of $12,000. The issue is requirement iii – this exchange is not solely in like kind. Real estate for real estate is like kind, but you also have the construction equipment. So this is a scrambled transaction.
      - If you unscramble it, you get $86K of apartment building for $86k of land, and $12k of apartment building for $26k in equipment.
      - Basically, this is realty for personalty, which usually isn't eligible for non-recognition. Maybe you could try to argue that the equipment is to build a new building on the unimproved land, so it's really like realty for realty. However, if the court doesn't buy your argument then you must apply §1031(b).

- §1031(b) applies to in part like kind and part not like kind exchanges. Gain is recognized to the extent of any money received and the FMV of the boot.
  - You recognize gain to up to the amount of the boot under §1031(b), so here you have $12,000.

c. TP's basis is governed by §1031(d).
  - Basis of Property Received = Basis of Property Given Up – Cash +/- Recognized Gain/Loss
    - So: 100,000 – 0 + 12,000 = $112,000 in total basis for all property received.
  - Allocate the basis first to the boot, it gets the full FMV as basis. Whatever is left goes to the like kind property.
    - So: Equipment Basis: $26,000 (If TP later sells the equipment, he'll see no gain or loss if he sells for the present FMV, as he's already been fully taxed on all of the gain. His basis should be and is the FMV).

      Land Basis: $86,000.
    - To the extent TP changes the underlying nature of his investment, to the extent he bails out of the real estate investment, it's fair to tax him.

d. What if TP in 3 had received equipment worth only $10,000?
  - Here there is a realized loss of $4k.
  - This is governed by §1031(c). In partially like kind exchanges involving a loss, the loss is never recognized.
  - TP's basis would be as follow: Basis of Property Given Up (100,000) – Cash (0) – Recognized Loss (0) = $100,000.
    - The boot always gets the full FMV basis so: Equipment Basis: $10k; Land Basis: $90k.
    - Because the basis in the land is increased, the $4k loss is in effect deferred until when the land is sold.

4. X has Australian money worth $20 and collectible US coins with a face of $20, but who's value was dependent on the coin collectors. These are not like kind.

E. More Realization and Recognition Problems, §1033 Involuntary Conversions

- Congress grants tax deferral on gain realized from involuntary conversions in large part because of horizontal equity concerns.
  - Left to his own devices, TP would probably not have been taxed because he wouldn't have sold the property. This is an involuntary realization event, so that justifies the gain deferral.

1. In 1995 St. Charles published plans which included TP's 50 acre tract of land within the boundary of a proposed park. TP, a construction contractor, had planned to develop the land into a residential subdivision. In 1998 the city offered to pay TP $1 million, the price he had paid for the land several years earlier. TP filed suit, contending the land had appreciated in value and the city's offer did not constitute just compensation. The city took possession in 1999 but placed $1 million on deposit with the court, and in July 2001 paid TP an additional $500,000 in compliance with the court's judgment. TP bought another tract for residential development in 1996 for $1.2 million. What is the tax treatment?

a. Realized Gain under §1001: $1.5M Sales Proceeds - $1.0 M Cost Basis = $500,000 Realization.

b. Recognized Gain? TP cannot rely on §1031 for a deferral because this was not an exchange of property, it's a cash sale. In addition, TP was going to sell the land as a residential development, so it was, in effect, his inventory, which would have excluded any exchange by virtue of §1031(a)(2)(A). That is the inventory exception.
  - In addition, in an inventory situation such as this, there is no valuation or liquidity problem here. No capital lock in or equity concern. So all of those considerations that led to nonrecognition in §1031 do not apply to this case.

- What about §1033? §1033(a)(2) covers this situation because TP got money. Under §1033(a)(2), gain from cash is recognized to the extent that the amount realized upon the conversion of the property exceeds the cost of such other property.
  - So, in this case, $300,000 would be recognized, taxable gain. The cost of such other property was $1.2M and he received $1.5M. The other $200,000 of realized gain will be recognized at TP's election. The $300,000 represents the extent to which TP bailed out of the investment.

c. §1033 Timing Requirement: §1033(a)(2)(B): Start the time clock on earliest of the date of the threat of requisition or the date the condemnation of the converted property to replace the property, you have two years from the close of the taxable year of whatever the earliest was.
  - §1033(a)(2)(A)(ii): You can replace the converted property prior to the date of conversion provided you hold that property on the date of the disposition.

- So it is okay that TP bought replacement property in 1996. Even if he had waited under October 2003, he might still be fine. The disposition took place July 2001, so he would have two year from January 2002. However, you could argue that the first threat was in 1995 when the city published plans. But is that definite enough?
  - Case law has held that merely publishing plans of a fairly definite character is usually enough to constitute a threat.

2. Same facts as 1, except now TP buys other land in 2003 for $1.6 million, one-half to be used for residential development and one-half for a golf course.
   - §1031(a)(1): Conversion into similar property: The property must be "similar or related in service or use to the property converted."
     - How to define "similar or related in service or use?" There is no definition. Congress wanted a strict "functional equivalent" test. This is much stricter than the §1031 like kind substantial similarity test.
     - Maybe you can argue the golf course is just party of the wealthy suburban development. Assume it does qualify. Then he's not forced to recognize any gain, because he put all it and then some into the new land. His basis would be a total of $1.1M.
   - Assume the golf course doesn't qualify. Then he's used his money to buy land for residential investment and a golf course. Under §1033(a)(2)(A) Recognized Gain =
     Amount Realized: $1.5M – Cost of Other Qualifying Property: $800,000 = $700,000. So you would recognize gain only to the extent of $700,000. Here there was $500,000 in realized gain, so you would recognize it all.
   - TP's basis in the land would be $800,000.
     TP's basis in the golf course would be $800,000 – he was taxed on all of the gain, so he gets a FMV basis.

3. Same facts as above but now TP's threatened property is a retail store, and TP waits until mid-2004 to buy an apartment complex for $1.2M.
   - §1033(a)(1): Are the retail store and the apartment complex functionally equivalent? No. So this section will not help him.
   - §1033(g)(1): A special rule for condemned real property held for productive use in trade or business or for investment. Under this rule, the "like kind" test applies, not functionality. Since this was real property used for a business, it would seem to qualify.
   - §1033(g)(4) gives you 3 years, rather than 2 years from the end of the calendar year of the earlier of the date of threat of condemnation or actual disposition of the property. So the 2004 timeline is okay.
   - §1033(g) does not cover all the same types of involuntary conversions as §1033(a). For example, §1033(g) does not cover theft or destruction in whole or in part.
   - TP would realize a $500,000 gain and recognize $300,000 of it. He is taxed to the extent he doesn't reinvest his money in a timely manner in like-kind property.
     - TP's basis in the property would be the cost of the new property decreased by the amount of gain not recognized. So he would have a $1M basis in the apartment complex.

F. §121 – Realization and Recognition on the Sale of Personal Residences

1. §121 Generally
   - §121 forgives the gain on the sale of a personal residence up to $250,000 for an individual, provided the TP used the property as his personal residence for at least 2 of the last 5 years.
   - There is no associated basis provision, so the owner's basis in whatever new property he buys is the cost of the new property.

a. Policy
   - Why have this tax forgiveness? Middle class homeowners vote. There's a long history behind the section. It used to be a once in a lifetime exclusion for those over 55. Now, there's no age limit so long as you use the house as your principle residence. So you can take the exclusion every 2 years.
   - So, appreciation in owner-occupied housing is free. Without this exclusion for the elderly, they would hang on to their big houses until they die, when the appreciation would be forgiven. So Congress doesn't make them wait till they die. It prevents capital lock in.
   - Previously, under §1034, there was a nonrecognition rule for owner-occupied housing. No gain was recognized provided you bought a new house within 2 years. However, there was a boot rule, and you were taxed if you bought a cheaper house. So to the extent you didn't reinvest your money in housing, you were taxed.
     - A combination of involuntary transactions, horizontal equity and capital lock in compelled Congress to enact §121.

- The old §121 was a once in a lifetime opportunity for those over 55. The new §121 amended that and repealed §1034. Most of those who used §121 had been non-recognizing/rolling over their gains from previous houses over their lifetime. So since they were deferring all their gain until after 55 anyway, why not just simplify. Which is what Congress did. You can take the $250K exclusion as much as you want. If you have a house that is really appreciating, you might want to sell it to maximize tax forgiveness.

2. TP's kids have grown up and moved away from home. TP, who is unmarried and 63 years old, sells the family residence for $400,000. She had paid $180,000 for it in 1985. Later this year, TP buys a smaller house for $150,000. How is the sale of the residence taxed?
   - Realized Gain: Amount Realized (400,000) – Basis (180,000) = $220,000.
   - Recognized Gain: §121
     - Under §1001(c) all realized gain is immediately recognized unless you can point to a specific exemption. §121 gives a specific exemption in this case.
     - §121(a) is not non-recognition – it's an exclusion (like meals and lodging or fringe benefits). There is no associated basis rule that will result in the IRS catching up with her later. This is truly forgiveness. There are limits to the exclusion: $500,000 for joint returns and $250,000 for individuals.
   - Basis: Because there is no associated basis rule in §121, she must use §1012. §1012 defines basis as cost. Her cost of the new house is thus her basis: $150,000.

G. Cottage Savings

General Rule: The realization requirement applies to both gains and losses.

1. Case Facts:
   - Inflation, in substance, is a tax. Anyone who owns dollar denominated investments pays an inflation tax. The value of the fixed dollar goes down. More retirees have dollar denominated investments. Carter tried to halt bad inflation by tightening the money supply. This caused mortgage rates to rise from 8% to 18% in 2 months. Once interest rates shot up, the value of the old loans went down. So there was a swap of mortgage loans by several savings and loans in Cincinnati. The current FMV of the loans was much less than the amount that was actually loaned. So the government gave the Savings and Loans a tax subsidy, which was in effect, government assistance in fraud to the investors.
   - The TP argued that this was a realization event, so they should be able to take losses on their loans. That this was an exchange in substance. When you exchange Blackacre for Whiteacre you are in effect selling off Blackacre and using the cash to buy Whiteacre, so there is realization.
   - The IRS argues that nothing happened. Maybe in form it's an exchange, but in substance it ought not to be seen as a sale. There hasn't been any real change in your economic position. The new loans you swapped for are so similar for tax purposes that there was no real change. Economic substitutes shouldn't be recognized. Economically equivalent = no realization according to the IRS.
2. Analysis
   - Under Bruun there would be realization. The transaction is over, complete, and there has been a severance from the risk of the underlying investment.
   - The court said there was realization here because the exchanged items were "materially different." Material difference is any significant difference in legal entitlement. Stock swaps of companies in different states are materially different.
     - Material Difference appears to be a low standard.
   - The court also notes that in §1031, the "like kind" standard is also relatively low.
   - §1001(a) – if you sell for cash, there's realization of gain or loss. What is an "other disposition?" This is not defined in the Code. This is why Bruun was before the Supreme Court – was getting the building back an "other disposition?"
     - Congress doesn't define "other disposition" because it can't. It's the duty of the courts to decide what is a disposition that can constitutionally trigger realization.
   - In this case, all parties assume that just because it's realized, the loss is also recognized. Under §1031, no gain or loss is recognized in like kind exchanges. This is not a like kind exchange because it is specifically exempted under §1031(a)(2)(C) – the swapping of mortgages doesn't fall under the non-recognition rule.
     - §1031(a)(2)(C) – "other securities or evidence of indebtedness or interest."
   - Because §1031 doesn't apply, all gains and losses must be immediately recognized. Under §165, Congress has granted Cottage Savings a loss deduction.
       - §165(a): "There shall be allowed as a deduction any loss sustained during the taxable year not compensated for by insurance or otherwise."
         - "Loss sustained" = Loss Realized

XII. Gains and Losses

A. Losses Generally

- Losses: In principle, you should get a deduction when you have a loss because we tax enrichment, and losses mean you have been disenriched.
- 3 Requirements for Losses:
  (1) Realization: The loss must be realized (Cottage Savings)
  (2) Recognition: §1001(c): All realized gains and losses must be immediately recognized.
    - There are some exceptions to the immediate recognition rule. For example §§1031– although you can always sell for cash and take your loss immediately, and 1091 – wash sale rule.
    - §1001 Loss: Adjusted Basis – Amount Realized
  (3) Allowance: §165(a): There will be allowed as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise.
    - You don't get a deduction unless you can point to an express statutory deduction authorization.
    - §165(c) limits losses on individuals to:
      (i) Losses incurred in a trade or business;
      (ii) Losses incurred in any transaction entered into for profit, though not connected with a trade or business;
      (iii) losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.
  (4) No Disallowance: You need to be sure that Congress hasn't disallowed the loss somewhere else.
    - For example: §262(a): No deduction for personal living expenses.
    - For example: §267(a)(1): Losses on sales between related parties are not deductible. No losses are allowed between related parties because you can never really know the value. If you buy GE stock at $100 and sell it to your brother for $70, how do you know TP isn't making a gift of $30, etc. It might be part sale, part gift. Gifts aren't deductible anyway.
- Personal property, over time, it worth less money, but that's because you used it. Therefore, you don't get a deduction. No deduction for consumption. §162(a).
- Losses from houses are not deductible. §165(c)(2). It is a scrambled transaction, partly for consumption, partly for investment, so Congress treats it all or nothing, and here you get nothing – no deduction.
  - Now if your house burns down, and you have no insurance, the loss would be deductible as a casualty loss under §165(c)(3). The house burning down is disenrichment. If the house was insured, however, no loss deduction is allowed.

B. Capital Gains and Losses:

1. Capital Assets

- §1221 – Definition of a Capital Asset: "The term capital asset means property held by the taxpayers (whether or not connected with his trade or business), but does not include:
  - §1221(1): Inventory Exception: Inventory is not a capital asset. Goods held for sale generate ordinary income.
  - §1221(2): Depreciable or Real Property Used in a Trade or Business: Property that declines in value over time through use of the property.
    - Quasi-Capital Assets: Depreciable business property or business real estate.
    - §1231 property is another name. Under certain circumstances, §1231 Property is treated as a capital asset.
- Generally, almost everything is a capital asset, and the sale of capital assets gives you capital gain.
- §1222 is the Capital Gain/Loss definitional section.

2. Capital Gains

- §1222(11): Net Capital Gain: Excess of the net long term capital gain for the taxable year over the net short term capital loss for such year.
- §1(h): Capital gains are taxed lower than most people's income tax bracket.
  - §1(h)(1)(C): Maximum rate is 15% of the net capital gain.
- Why is the capital gains rate reduced?
  - Maybe the gains are unreal? Maybe there's an increase in inflation. Nominal gains or losses might have nothing to do with inflation. Maybe that's why we're hesitant to impose normal tax rates.
  - Maybe in terms of vertical equity, it's unfair to tax gains all in one year that accrued over many years. You'd be pushed into a higher tax bracket.
  - You also have to worry about bunching. There are ways to solve the problem of taxing years of accrued value in one year (i.e. averaging).

- Why has an across the board reduced rate? We have a generalized tax incentive for long term investment. Congress is responding to a capital lock in problem. They don't want to deter people from responding to the market. Congress is saying we have to bribe people to take their profits with a reduced rate of tax. We want people to take their profits and reinvest them when its optimal for them to do so.
- The realization requirement is the problem. Why not dump the realization requirement? If we taxed year by year appreciation, you'd never have capital lock in and people would always be free to switch investments.

3. Capital Losses
- §1211: Capital losses are deductible only against capital gains for businesses.
- Capital losses are deductible against capital gains, plus $3,000 for individuals.
- §165(f): Losses on the sale or exchange of capital assets are allowed only to the extent of §1211 and §1212.
  - §1212 allows you to carry forward excess capital losses to later years.
- Why are capital losses limited only to the extent there are capital gains?
  - Realization Requirement: This keeps people from selling all their losing capital assets to take the losses while keeping all their gains and never paying tax.

XIII. Tax Treatment of Loans

A. Loan Proceeds
- Not income under §61. There's a legally enforceable obligation to repay the loan in full, so the offsetting liability means no net increase in net resources, so no income.

B. Principal Repayments
- Decrease in cash resources that is decreasing your liability. No income tax effect. Your wealth remains unchanged.
- No deduction for payment of principal.

C. Interest Paid
- Depends. What were the loan proceeds used for? Business? Investment?
- §162: Interest could be deductible as a business expense.
- Loans to finance consumption are not deductible expenses. §262.
- §163(a) allows a deduction for interest paid on a loan generally, and made no distinction between the different types of loans. However, Congress has been cutting back over the years and it moving toward to theoretically correct approach used directly above.
  - §163(h): Home loan interest is deductible.

D. Aside – What is a Bond?
- Bonds are long term negotiable loan contract. Negotiable means the lender's rights are transferable.
- The issuer of a bond is the borrower (often a corporation or government entity)
- The initial purchaser of the bond is the lender.
- Bonds are freely transferable. Current owners (the bondholder) often is not the lender.
- Maturity is the duration of the loan.
- Example: The state of MO sells a bond. MO is the debtor, you are the creditor. MO will pay the creditor interest until maturity, then the debtor pays the bond principal back in one lump sum.
- Example: Owner of a 20 year, 10% interest, face value of $1000 bond, sells when there is still 10 years to maturity. How much will you pay for it if newly issued 10 year bonds bear interest at:
  a. 10%: $1000
  b. 8%: $1134.20: Present value at 8% of $100 per year for 10 years + $1000 10 years later.
  c. 12%: $889.92: Present value at 12% of $100 per year for 10 years + $1000 10 years later.

E. Kirby Lumber:

1. Case
   - Kirby issues bonds to the public. A few years later, they are able to rebuy the bonds for less than when they were issued. The interest rates went up (scenario c above). Say they sold at $1000 and rebought at $900. When the sold the bond, they got $1000 in loan proceeds. This was not taxed. But now, they have $100 of loan proceeds they will never have to pay back, so this is a taxable windfall.
   - The court held that this is income from the discharge of indebtedness.

2. Congressional Response to Kirby:

- §61(a)(12): Congress codified Kirby: Income from the discharge of indebtedness is taxable income.

3. Insolvency Exception (Lakeland Grocery)
   - Discharge of indebtedness. But the borrower is insolvent both before and after debt reduction. You have a $1000 corporation X bond. Corporation X repays $400, but they never have to repay $600 of the loan proceeds.
   - Corporation X has $600 less of debt, but are the shareholder enriched? No. The company is still insolvent so you can make an argument of no enrichment.
   - The court in Lakeland agreed and said no enrichment, no taxable income. But there were limitations.
     - Corporation is insolvent $300
     - Debt is reduced by $600
     - Corporation is now $300 solvent. So this $300 would be taxable.
   - So Lakeland applied to insolvency before and after. This happens often – insolvent corporations get reduction in liabilities for their creditors, even though they will still be insolvent afterwards.
   - 2 Views:
     a. No enrichment because the shareholders' wealth did not increase (Enrichment Rationale).
     b. Focus on the land transaction – The corporation still received tax free proceeds that were not repaid (Recapture Rationale – Inclusionary Side of the Tax Benefit Rule).
   - If you don't have an insolvency exception, it seems counter-productive to have an immediate tax on financially distressed debtors and makes it unlikely they will emerge from insolvency.

Congress' Response to Lakeland Grocery:
- §108(a)(1): Gross Income does not include amounts that would be included in gross income be reason the discharge of indebtedness of TP if:
  (i) Discharge occurs while you're in bankruptcy;
  (ii) Discharge occurs when TP is insolvent (liabilities exceed assets).
- §108(d) is the definition subsection.
- Is this exclusion forgiveness or deferral?
  - §108(b) imposes some restrictions.
  - §108(b)(2)(A): Net operating losses must be reduced by the amount of the discharge of indebtedness. So you can't carry the net operating loss carryover deduction to future years. This is thus tax deferral, NOT forgiveness.
    - So Congress is adopting the Recapture Rational – rejecting Lakeland Grocery.
  - Moreover, under §108(a)(3) the exclusion applies only up to the amount of the insolvency.
- §108(b)(3) – Reductions are generally dollar for dollar, but if you're reducing credits, the reduction is 33.3 cents for each dollar excluded by §108(a). So $1 credit = $3 deduction.
- §108(e)(1): There shall be no judicially recognized insolvency exclusions except those authorized by Congress.

F. Discharge of Indebtedness
1. What constituted indebtedness? Not every reduction of stated liability triggers income.
- Discharge of indebtedness treatment reasons that you're taxed because the IRS goofed in not taxing you on what we thought were loan proceed that you would pay back.
  a. A promises under seal to make a gift to her son. Her son subsequently releases her from the promise. This is a legally enforceable liability to make a gift. But A hadn't received anything, so there is no tax on the discharge. She received nothing tax free that we are allowing her to keep.
  b. B promises to make a $1000 contribution to a church's building fund. Subsequently, the church agrees to accept $500 in full satisfaction of the pledge. There is no discharge of indebtness. Nothing was received here tax free.
  c. D receives a bill from his lawyer for $1000. In the following year D complains about the bill and the lawyer agrees to accept $600 instead of $1,000. This is not a discharge of liability, it is a dispute about the amount owed. A legitimate dispute as to the extent of indebtedness is fine. This is a purchase price adjustment under §108(e)(5).
- What constitutes discharge? Discharge is nonpayment when you have forgiveness. Be careful to distinguish satisfaction from discharge (forgiveness).
  a. A's employer pays all federal income taxes imposed on A by reason of A's salary. This is payment of indebtedness, not discharge.
  b. D, an amateur painter, receives a bill for $800 from his lawyer. Being short of cash, he persuades the lawyer instead to accept one of his paintings. This is payment in kind, rather than in cash. This is not discharge or forgiveness. The lawyer would be taxed on the $800 of gross income from the painting. The

painter effectively sold the painting for $800 and used the $800 to pay for his legal services. So he is taxed on the $800 in sales proceeds less the cost of the painting (supplies, canvas, etc.). The $800 or so would be taxed as ordinary gain if this was his profession.

G. Zarin

1. Case

- In 1980 the Casino provides TP with $3.4M in chips (essentially promissory notes). In 1981, Zarin defaults, he pays $500k in full settlement. The IRS argues that he got $3.4M in chips, he promised to pay for them, but he never paid them back. So he got $2.9M of discharge of indebtedness income. Zarin cannot invoke §108(a)(1) for deferral because he was not bankrupt or insolvent. The court ultimately held that this was a contested debt.
- Zarin had 2 argumens:
  - (i) The debt was unenforceable, and thus the forgiveness isn't taxable.
    - Compare: TP1 who borrows $3.4M from the bank.
    - Compare: TP2 who borrows $3.4M from casinos and repays in full.
  - If TP1 was unable to pay and got $2.9M in forgiveness, he would be obligated to pay taxes on the $2.9M. But TP1 and Zarin are in essentially the same factual, economic situation. So there's a horizontal equity problem.
  - There's also vertical equity problems. TP2 would not have $2.9M that Zarin would.
  - If there's no income from discharge in 1982 because it's unenforceable, what was really happening in 1980 when they gave him $3.4M in chips? They goofed, they didn't know it was unenforceable. Or were they paying him salary for his services in attracting customers?
  - The implication is that this was a windfall of gross income.

  - (ii) Purchase Price Adjustment: §108(e)(5):
  - Zarin bought chips. Is that property? The chips really represent services, not property, so this was the purchase of services, not property.
    - Purchase price adjustment is really a retrospective recognition that you were overcharged for what you bought, so there's no discharge of indebtedness income. Congress had in mind lemon cars.
  - §108(e)(5) turns on the actual value of the property. Here's there no dispute as to the value received.
  - However, maybe his best argument is that he is different from everyone else that bought chips on credit because the casino knew he was a compulsive gambler. They knew he wouldn't win and walk away. So maybe these chips ought to be seen as effectively a purchase price adjustment because he isn't getting the same value everyone else is getting on the chips they borrowed.
- Other Arguments He Could have Made:
  - (iii) Investment Loss Deduction
  - Ordinarily, gambling losses wouldn't be deductible under §165. This wasn't his trade or business and this was not involuntary disenrichment.
  - Zarin could try to argue that these gambling losses fall under investment losses. But was there really a loss? This was entertainment- consumption. No deduction is allowed for consumption. You might hope, though, that you make a buck.
  - §165 Wagering Losses: Allowed only to the extent of gains. In general, net gambling losses are not deductible because Congress treats this as consumption.
    - The IRS argues §165(2): $3.4M non-deductible in 1980. $2.9M discharge income in 1981. If you don't tax him in 1981, you're letting him deduct wagering losses from discharge income that arose in different years. So this goes against annual accounting §441(a).

H. North American Oil

1. Case

- Royalties on the production of oil were paid to a receiver in 1916. In 1917 there was a preliminary decision as to who was entitled to payment. There was an appeal to the Supreme Court in 1922. It was ultimately resolved that North American Oil would be taxed on the enrichment, but in which year?
- The IRS says the proper year is 1917. TP prefers 1916 or 1922, but not 1917 because the rates were at the highest then.
- §451 – General Rule for Taxable Year of Inclusion
  - §451(a): Default rule is the year of receipt, unless the company uses a different method of accounting.
  - §446(a): Tax accounting year is the company's financial accounting year.
  - §446(c): TP's may use cash basis or accrual method. In this case, we don't know which North American used.

        - §1.451-2(a): Under the cash method, you report income when received. North American Oil had no right to get the money in 1916, so no there was no actual or constructive receipt then.
        - §1.451-1(a): Under the accrual method, you report income when all events have occurred that fix the taxpayer's right to the income, and the amount is reasonably estimable. Once you've earned it, it counts even though you may not get the money until the end of the next year.
            - Problem: Have you really satisfied all events necessary to get the money? Not in 1916. What about 1917?
    - TP's Ingenious Argument: This is Loan Proceeds: Can the taxpayer argue that even under the cash method, there's no income for 1917 because this is loan proceeds? TP got the money, but they may have to pay it all back. In 1922 it's finally decided that the taxpayer doesn't have to pay back the full amount of the loan proceeds, so 1922 would be right.
        - If you treat the money received in 1917 as a loan, then there would be discharge income in 1922 when the appeal was resolved in North American's favor in 1922.
        - Loan tax treatment is preferable because TP could have gotten a deferral.
    - The Court rejects the taxpayers loan argument and instead adopts a claim of right argument. Under a loan there is an obligation to repay. Here, there is a highly conditional, uncertain obligation to repay. You only have to repay if you lose the appeal.
    - In addition, the SC requires cash flow income. In 1917 the royalties are reported. If they had lost the royalties in 1922, they could have gotten a deduction.
        - Why Cash Flow?
            - Enrichment: If you do not have an unconditional obligation to repay, there is some amount of enrichment. Enrichment would depend on the probability of repayment. This calculation can be messy.
            - TP Compliance and Administrability: If TP had won in North American, no taxpayer would pay taxes, they would always argue that there was a loan that they might have to repay. Would this amount to infinite tax deferral? No, only till the statute of limitations ran on the ability to recover the money. It is not a good idea to make timing of income dependent on the state's statute of limitations. It's too hard to administer. TP's argument would be unenforceable.
    2. Rule
        - Claim of Right Doctrine: If a TP receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

I. Lewis Case

1. Case
    - Lewis gets a bonus, and then has to pay it back. In 1944 he got a $22k bonus, and he paid tax on the income under cash flow/claim of right doctrine. In 1946, he has to repay 11k, so he gets a deduction. TP wants to be not taxable at all on the $11k he has repaid. Because of a decrease in rates, he's getting screwed. He wants to amend his 1944 return.
    - The court says no no, §441 – income is taxed in the taxable year, so TP is out of luck.
    - The problem is giving a deduction in 1946 instead of refunding the tax he paid in 1944. Why not give him a tax credit in 1946 for the extra taxes he paid on the amount he didn't get to keep? The judiciary cannot authorize a tax credit.

2. Congress' Response §1341
    - Congress addressed this in §1341(a): Congress authorized a credit – TP's are allowed to choose a deduction or a credit. This was enacted to do complete justice. If the rates had increased from 1944 to 1946, no one would claim the credit, they'd take the deduction and you'd end up underpaying your taxes. So the Treasury is suffering in either case.

J. James v. US

1. Case:
    - James was a union official who embezzled about $738k over four years. He failed to report these amounts in gross income. The embezzler always has an unconditional legal obligation to repay the embezzled money in full, so it would seem that the claim of right doctrine does not apply to make the embezzled funds gross income.

- The court says that the function of the claim of right doctrine is to not grant tax deferral when there is uncertainty as to repayment; when there's a conditional legal obligation to repay. But Claim of Right applies to loans.
- The Supreme Court says this is not a loan – the repayment obligation isn't real because 99% of the time, the embezzler will have already blown the money. Illegal income, moreover, should not be tax exempt.

K. McKinney v. US

1. Case
   - McKinney embezzled funds and then actually repaid them. He wanted to take a deduction under §172 or a credit under §1341. In 1966 $92k was embezzled. He paid tax on the money, reporting it in his gross income. In 1969, he repaid all of it in full. He takes a deduction on what he repaid, but he was unhappy with the deduction because he didn't have enough income to get the benefit of the deduction. He argues §1341 – I get a credit for the extra amount I can't deduct.
   - §1341 doesn't apply here because he has no legal right to the money, not even an uncertain legal right. So §1341 doesn't work.
   - He then tries to take a net operating loss carryover under §172. The court says no to this because he was not embezzling as a trade or business. This was recreational embezzling.

XIV. Tax Treatment of Non-Recourse Loans and Mortgages

A. Generally

1. Gain Generally

- When you have a realization event, we try to measure the excess of the FMV of the property sold over your remaining tax paid investment.
- There is no increase in resources on sale or exchange. When you sell a stock, you go from having the stock in kind to having cash. We tax you only because we didn't tax you before when the wealth arose because of appreciation.
- Gain = Enrichment = Increase in wealth due to an increase in the value of property over tax paid investment.
  - §1001(a): Amount Realized – Adjusted Basis = Gain (loss)
  - FMV of Property Disposed – Remaining Tax Paid Investment = Appreciation (Accession to Wealth)
    - Adjusted Basis = Basis (§1012) +/- Adjustments (§1016)(often depreciation)
      - But §1012 doesn't pay attention to whether the basis is actually your tax paid savings. It could be a loan, etc. But this makes sense because even if you borrow the funds to buy the property, you will eventually pay a tax when the loan is paid back. So conceptually, adjusted basis is correct.
    - Problem: Amount Realized = §1001(b): It's underinclusive: Cash Received + FMV of the Property
      - If you read the statute literally, there's a problem if you exchange, say, a computer for X's help as a research assistant. There's no cash and no "property." You are getting services. But form of receipt under Old Colony is irrelevant, so you would be taxed on the value of services.

1. Non Recourse Loans

- RULE: Principal Amount Outstanding on Non Recourse Loan is the Amount Received.
- What about non recourse loans where the seller is not personally liable?
- FMV is what we care about; the unencumbered, fmv, the gross fmv, we don't care about the seller's equity. The message is that you need to measure the increase of the value of the investment over the seller's tax paid investment.
- What happens if the value of the property falls below the value of the loan? If you put the amount realized at the outstanding balancing of the mortgage, it doesn't accurately measure the property's fmv. But this is the rule.

B. Tufts Case

1. Case
   - Construction of an apartment building was financed with a non recourse loan. The FMV of the property at the time of sale was $1.4M. The mortgage principal was $1.8M. The owner of the property had a $1.46M basis in the building when it was sold.
   - TP's basis in the property = Cost (1.8M) – Depreciation Adjustment (340k) = $1.46M.

2. TP's Argument
   - TP argued that he received nothing out of this, but concedes there may be gain or loss on the building. He argues that he has a $60,000 loss on the transaction:
     - Amount Realized: $1.4 – Adjusted Basis: $1.46 – ($60,000)

3. IRS' Argument

- The IRS says he has a $340K gain on the transaction. The IRS uses the same calculation as if it were a recourse loan:
  - Amount Realized: $1.8 (Full Outstanding Principal Value of Mortgage) – Adjusted Basis: $1.46 = $340K gain.
- The court ultimately adopts this argument and treats is as all taxable gain from the disposition of property – capital gain taxed favorably.

4. Theoretically Correct Argument
   a. Scrambled Transaction
   - The theoretically correct approach is to look at this as a scrambled transaction – partly a loan transaction and partly a sale of real estate.
     - TP originally received $1.8M which was invested in the building. This was a loan, so they didn't pay tax on it, as they were under an obligation to repay it.
     - If TP had transferred the building back to the bank to foreclose, the bank is only getting $1.4M in value, not $1.8M. This leads to the conclusion that there were $400K in unpaid loan proceeds. So you have discharge of indebtedness income under §61(a)(12).
       - So: $400K of discharge income - $60K loss from the sale of property = $340 gain (phantom gain)
       - Now, the $60k loss from the sale of property could potentially be a non-deductible capital loss, while the $400K discharge income is ordinary income.
       - But, under the opinion, the whole thing is treated as gain from the disposition of the property and taxed as a capital gain, so it gets favorable treatment.
   b. Tax Benefit Rule
     - Tax Benefit Rule: In a sense this is sort of like a tax benefit problem: A person doesn't pay off a non recourse loan if the value of the collateral falls below the outstanding principal. You just walk away and let the bank have it.
       - Non recourse loans are treated as true loans though.
   c. Loan Tax Treatment vs. Cash Flow Treatment
       - Under cash flow treatment, if there is a conditional obligation to repay, we tax every penny. If you repay the money, you can have a deduction.
       - Under a non recourse loan, there is a conditional obligation to repay. You repay if the collateral is worth the same or more than the loan, if not, you walk away. So we could tax you on the proceeds of the loan, and if you pay them back we could give you a deduction. But we don't do that. Why?
         - First, this condition almost never happens. The mortgagee almost never treats the loan as if it's a real loan.
         - Second, historically, we've treated them as real loans. So non recourse loans get loan tax treatment, not cash flow treatment.
   d. Tufts Recourse Loan
       - If this had been a recourse loan, chances are the bank would forgive you the $400K in deficiency:
         - $1.8 Loan Principle - $1.4 FMV = $400k deficiency. The forgiveness of the $400K would be taxed as ordinary income.

5. FMV in Case of Non Recourse Indebtedness §7701(G)
- §7701(G): FMV in the case of non recourse indebtedness = The amount of any non recourse indebtedness to which the property is subject.
- Congress essentially codified Tufts. They didn't unscramble the scrambled transaction.

C. Examples
- Seller Personally Liable: X sells Y Blackacre. Blackacre has a FMV of $1.2M. X has a purchase money mortgage on it of $1M. Y might pay X $1.2M or Y might pay X $200K and assume the mortgage responsibility. Any amount Y agrees to pay off is treated as constructively an amount realized. This is an easy case where the seller is personally liable.

XV. Tax Treatment of Gifts
- We have not adopted a general principle of realization by gift or bequest.

A. Ordinary Cash Gifts to Friends and Family

1. Donee: Are gifts received income?
   - §61(a) says "except as otherwise provided… gross income means all income from whatever source derived…"
   - So technically, gifts would seem to be windfall income that is unquestionably gross income under §61.

2. Donor: Are there deductions for gifts given?
   - The gifts are from after tax income. The donor has paid tax earlier.
   - This is not a cost of producing income so there would be no deduction for that. But what about a deduction for loss, disenrichment?
      - Material Consumption Theory: The donee gets the benefit of material consumption, so don't tax the donor. That would argue in favor of giving the donor a deduction.
      - Intangible Consumption: As an alternative to giving the gift, the donor could have done whatever he wanted with the money. What does this say about the value of this gift to the donor? It tells us that giving the gift was more valuable than using the money on anything else. So perhaps the donor has intangible consumption. In such a case he should be taxed. So this would argue against giving the donor a deduction.

3. Alternative Definitions of Income - §102:
   a. Material Consumption Focus/Private Preclusive Consumption: Tax the donee only; give the donor a deduction.
   b. Intangible Consumption Focus: Tax the donee; No deduction for the donor.
- Both a and b are theoretically plausible alternatives for the reason noted above in 2. However, Congress didn't adopt either of the theoretically correct alternatives:
   c. Tax Donor Only – This was the method adopted by Congress.
- §102(a): Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.
   - §102 is an express exclusion for the donee to not have to pay tax on the windfall. Under general tax principles, the donee would have to pay tax, so Congress passed the express exclusion.
   - Under §102, the donee does not pay tax, but the donor does not receive a deduction for gifts given (except in the case of charitable gifts under §170). Deductions are a matter of legislative grace, and here they didn't grant a deduction.
   - So, donor only is taxed by not getting a deduction.

4. Policy Behind §102
- What led to Congress' approach? Either of the theoretically correct approaches would have cause huge administrative problems.
   - Material Consumption Focus: For example, feeding your kid dinner is a gift. How much is that worth? How much of an electricity gift did you give little jr.? So if you take this to its logical extreme, it gets really hard to carry out.
      - Also it leads to the conclusion that gifts should be taxed at the rate of the person who received the gift. But if Jr. gets a gift of $10K from mom and he buys a car, but only mom drives the car, Mom using Jr. to get the lower rate. It's disguised consumption. The IRS would have to audit who used what, and this is too difficult to police. In addition, you'd have the prospect of invasion of your private life.
   - Intangible Consumption: The giving of the gift is the purchasing of intangible benefit, satisfaction. What's the problem with this approach? If we don't give the donor a deduciton, how do we know about the donee's gift? The donor won't report it, and only the honest donees would report the receipt of a gift. So this is a tax on honesty. So in practice, under this approach, we end up with §1021(a) – taxing the donor only.
   - §102 is administrable and allows the IRS to tax at least some portion of the gift situation.

5. Irwin v. Gavit Split Interest Gifts:
a. Case
   - TP received a 15 year income interest in a testamentary trust.
   - §102(a) includes gifts by bequest or inheritance. TP argues he got this under a will, so it's a bequest.
   - §102(b) is a limitation on the exclusion granted by §102(a). At the time of this case, only §102(b)(1) existed; §102(b)(2) codified the court's holding in Gavit.
   - When you receive Microsoft stock as a bequest, for example, the value of the stock is excluded, but any dividend or other income arising from the stock is taxable under §102(b)(1). Congress didn't want to exempt all future income of the gift.
- §102(b)(1) acts to tax income from a gift.
   - In Gavit, there was a gift only of an income interest, not the principal. So under a literalist interpretation of §102, both the gift of interest to Gavit and the gift of principal to Gavit's daughter would be tax free. In this way you could exempt taxing the income from gifts by simply splitting the property. Congress and the court rejected this.
- §102(b): All income property is taxed, even if you have a gift of just interest – just the income.

- So Gavit had to pay tax on every penny of income he received for his 15 year term.
- At the end of the 15 years, the daughter gets the principal, and she will not be taxed on the principal. The property itself was the subject of the gift, not the income. So the principal beneficiary enjoys the full benefit of §102's exclusion.

6. Example:

- Purchaser of income interest: Buyer paid Gavit $100k for his 15 year income interest.
  - The purchaser will be taxed on the income distributions of the trust. But say the purchaser gets $120k over 15 years, but he paid $100k to get that.
    - The purchaser will get his cost basis – his tax paid investment – back tax free. But when the 15 years is up, and the investment is worth nothing, his basis is 0. So the purchaser gets a depreciation deduction over the 15 years for this wasting asset.
    - His depreciation will be $100k/15 years – Straight line depreciation.
  - §167: Depreciation/Amortization Deduction.
  - §273: Purchaser of an income interest gets depreciation deduction, but the donee does not.
      - So for the donee, inclusion under §102(b)(2) and no allowance for shrinkage under §273.

7. Example:

  - Assume 15 year term interest, principal = $100k; Expected Income = $8k per year.
  - Donee of life estate or term interest or income interest:
    - All payments: Gross Income: §102(b)(3)
    - No depreciation deduction: §273.
  - Donee of remainderman or principal interest? §1026 Exclusion.
    - The principal beneficiary will take advantage of §102(a) and claim an exclusion, regardless of whether the FMV has gone up or down.
- What is Gavit sells his income interest of $58k? Gavit will be taxed on his gain. §1001
  - Gavit, as donee, has a basis of $0. He will be taxed on every penny of the distribution under the trust, so he will also be taxed on every penny if he sells the interest.
  - §1001(e)(1) say the donee of a life estate, etc. will have a basis of $0 fi he sells that interest. Income beneficiaries, life tenants, etc. have a basis of $0.
- What is the remainderman sells his principal interest in the trust?
  - Gain of Loss = Sales Proceeds, Say $42k (the present value) – Adjusted Basis (Remainderman get the full basis of the property, but only when they actually get possession of it).
  - So the remaindermen do get some basis, but the details are messy. They effectively get their share of the present value, as specified in §1.1014-5; 1.1015-1(b). But it's not necessary to know the details.

B. Tax Treatment of Gifts in Kind (Property)

1. §1015

- §1015 is the associated basis rule for inter vivos gifts. Under §1015:
  - The donee takes the donor's basis for determining gain.
    - So you are getting tax deferral for the gain. And can effectively choose the tax rate you want.
  - The donee takes the FMV of the property at the time of the gift for determining loss.
    - If the donee will take a loss, the donor should just sell the property and take the full loss allowed.
    - §1015 disallows the full extent of the loss because it would allow taxpayers to choose the tax rate that would give them the best deduction. Congress is saying don't be a pig. The loss deduction is going to far. Sell it for cash and then make gift of the proceeds.
  - There is neither gain nor loss if the donee sells for an amount between the FMV at the time of gift and the donor's cost basis.
- §1015 assures that we have tax deferral and not tax forgiveness.
- §1015 prevents liquidity problems.
- You give highly appreciated stock to your kids, relatives who have a lower tax rate. So this gives you the power to determine the rate of tax.

a. Example:

  - Donor has stock with a cost basis of $1,000. (§1012).
  - Donor gifts the stock to the donee, his niece. The FMV at the time of the gift is $2,000. The gift worth $2,000 is not taxable to the donee by virtue of §102.
  - The niece later sells the stock for $5,000.

- When to tax the appreciation?
    - Material Consumption/Private Preclusive Consumption: The niece has the benefit of consumption; the donor can't spend it on himself. Under this view, the donor would not be taxed on the $1000 in appreciation at the time of the gift.
    - Intangible Consumption: But maybe there's intangible consumption. The donor received value in his niece's gratitude, etc. Under this view, the donor would be taxed on the $1,000 appreciation at the time of the gift.
    - But we don't impose a tax on the donor, historically we take the material consumption (private preclusive consumption view) view and say that there's no realization, and no tax on the donor. But this presents the specter of the appreciation escaping tax entirely. We avoid this via a basis rule.
- §1015: Niece will take the basis of the donor. So, here the donor would have a $1000 basis, and donee would thus have a $1000 basis.
- When niece sells the stock for $5,000, she will have a basis of $1000 and will be taxed on the $4000 appreciation.
    - With this result, we are clearly taxing $1,000 to the wrong person. But that's how you do it.

b. Problems, pg. 154
  i. A bought shares of stock for $10,000. In 1986, when they were worth $16,000, he gave them to B, who sold the shares in 1998 for $15,000. How much gain or loss did B realize?
    - Cost = $10k; FMV at the time of Gift = $16k; FMV at the time of Sale = $15k.
    - Donee's Adjusted Basis = $10k (transferred basis/carryover basis)
    - Amount Realized = $15k
    - Gain = $5,000
  ii. C bought shares for $1,000. In 1995, when the shares were worth $600, she gave them to D. How much gain or loss will D realize if he sell for $1400?
    - Amount Realized: $1400 – Carryover Basis: $1000 = $400 Gain.
  iii. C bought shares for $1,000. In 1995, when the shares were worth $600, she gave them to D. How much gain or loss will D realize if he sell for $500?
    - Cost = $1000; FMV at time of Gift = $600; FMV at time of Sale = $500.
    - Amount Realized: $500 – FMV at time of Gift Basis $600 = $100 loss.
    - Loss = $100
    - Here, the donor should have sold the property and taken a $400 loss.
  iv. C bought shares for $1,000. In 1995, when the shares were worth $600, she gave them to D. How much gain or loss will D realize if he sell for $900?
    - D sold for an amount between the donor's cost basis and the FMV at the time of the gift. So there is no gain of loss.

2. Commissioner v. Early
- Here the Early's received stock certificates signed over to them. An inter vivos gift of stock. After the donor's died, the donor's estate wanted the stock back. The Earlys gave them the stock back in return for an income interest in the trust.
    - TP wanted to take a depreciation deduction. They argue since they bought their interest, §273 does not apply. This is an investment, not a bequest.
    - The IRS says the economic reality is that this is all one step. In form, it was cast as an outright gift followed by the purchase of interest in the trust. However, in substance this was all one transaction.
- The Court agreed with the IRS and properly so. The two steps weren't independent. The only reason TP gets to keep any value is because it relates back to the inter vivos gift. So always be sure to ask what is the underlying reality of the situation.

C. Property Acquired from a Decedent.
1. Donee
- §102: Donee is not taxed on bequests from a decedent.

2. Donor
- There is no realization by gift or bequest. The decedent is not taxed on the appreciation.

3. Later Sale by Heir
a. Use §1014 Basis Rule.
    - §1015 does not apply.

- Basis: §1014(a)(1): Donee gets: FMV basis at date of death – or - at heir's election , FMV basis at a date 6 months after the date of death (§1014(a)(2)).

b. Practical Implications:

- We forgive the tax on appreciation because we give a FMV basis. This is outright tax forgiveness.
- What about losses to wealth? They're gone forever. Not deductible for anyone. So wealthy individuals near death should sell their property that has lost value and take the deduction themselves.
- Lawyers refer to §1014 as the step up basis rule.
- §1014 results in a very substantial revenue losses for the Treasury, almost $393B per year. Why have it?
    - Political ramifications
    - Why not have a transferred basis at death? Capital Lock In problem.
        - Look at the family farm situation. Say the land was bought at $1,000 an acre, but not, when you as an heir get it, it's worth $10,000 an acre. The heir might be deterred by the large tax obligation from selling it and doing what he really wants to do. So we have a capital lock in problem. You can't sell the farm to do what you want – i.e. go to law school – because you're locked in.
    - The family farm also presents an economic neutrality problem. You can't sell the farm to do what you want to do.
- Why not tax mom and dad when they die? Realization at death? Then heirs and devisees would get a FMV basis.
    - Liquidity Problem: This would eliminate the capital lock in problem (although it would still be capital lock in during mom and dad's life, but not inter-generational as before). But this forces kids to sell the land to pay the tax at death of the parents. It's a liquidity problem.
- So both of the solutions have major problems, so we have §1014.
- What about realization at death and installment payments of tax liability? This is the obvious solution – a compromise between the other two options, but it's never been hit on.

c. §1014 Changes:

- §1022(a): After 2009, §1014 no longer applies. Property transferred at death will be treated as a gift. Thus, the §1015 basis rule will apply to bequests at death. No more forgiveness.
- This was enacted to go into effect at the same time the estate tax is repealed. This repeal is a one year deal then it will be reassessed.
- Only 1% of the population is subject to the estate tax at death. They get will get estate tax forgiveness. But now we collect tax on their appreciated earnings during life. Although only the wealthiest 1% suffered from the estate tax, the middle class now will suffer from the new §1015 basis rule.

D. Business Gifts

1.

a. §274(b): There is no such thing as a deductible business gift.

b. §102(c): There is no such thing as an employer-employee gift.

- If you're not in an employer-employee context, and the giver doesn't take a deduction, you apply the Primary Purpose Rule and might not have to pay tax on the value of the gift.
- If you're not in an employer-employee context, and the giver takes a deduction, it's not a business gift, since business gifts aren't deductible, and you will have to pay tax on the value.

c. Primary Purpose/Dominant Motivation Rule (Duberstein): Was it detached, disinterested generosity, or was it the constraining force of moral/legal obligation, also described as anticipation of future benefit?

- How to figure out primary motivation? It's a question of subjective motivation. We infer subjective motivation from the objective facts and circumstances.

2. Duberstein Case

a. Case

- Duberstein received a Cadillac from a business associate in thanks for his sales leads. Stanton received a $20,000 thank you from the church he worked for when he quit. Both wanted these gifts to be excluded under §102.
- The IRS wants a clear cut rule to make administration of gifts easier. They wanted essentially a no business gifts rule that would be applied consistently.

b. Court's Analysis

- There is no definition of "gift" in the code. So the court falls back on common usage. The court refused to apply the IRS's no business gift rule because of common usage. Coworkers often become friends and give true gifts. So this is in part a scrambled transaction.

- This is a mixed motive transfer: partly motivated by business considerations and partly by personal affinities. You can't separate the two.
- So the Supreme Court says you need an all or nothing rule. It's either all an excludable gift, or none of it is.
- The court uses the Primary Purpose/ Dominant Motivation Rule: Was it detached, disinterested generosity, or was it the constraining force of moral/legal obligation, also described as anticipation of future benefit?
  - How to figure out primary motivation? It's a question of subjective motivation. We infer subjective motivation from the objective facts and circumstances.

c. Congress's Reaction to Duberstein:
- §274(b): There is no such thing as a deductible business gift.
- §102(c): There is no such thing as an employer-employee gift.
  - If you're not in an employer-employee context, and the giver doesn't take a deduction, you apply the Primary Purpose Rule and might not have to pay tax on the value of the gift.
  - If you're not in an employer-employee context, and the giver takes a deduction, it's not a business gift, since business gifts aren't deductible, and you will have to pay tax on the value.
  - Now, you could try to argue, if you had Stanton today, that Stanton wouldn't fall in §102(c) because he's a "former employee." However, most would argue yes, he's an employee. Same thing if you tried to give a gift to an employee's wife – substance over form. This wouldn't fly.

XVI. Tax Treatment of Property Settlements

A. Property Settlements Generally

§1041

1. Rule: Realization occurs when you have a property exchange in release of a spouse's claims.

B. US v. Davis: A realization case

1. Rule from Case:
- Transfer of property in satisfaction of a legal obligation is a realization event because it's essentially a sale.

2. Case
  - Davis owned 1000 Dupont shares. In a negotiated property settlement, he gave them to his ex-wife. When Davis bought them he paid about $75k. The FMV at the time of the transfer was $82k. So there was $7k in unrealized appreciation.

3. Analysis

a. Davis
  - If you take the Bruun approach, we ask if the transaction is over. As to Davis, the investment transaction with Dupont stock is over. But did he get to enjoy the benefit of the appreciation?
    - Arguably, he used the appreciation to get rid of his wife. He bought peace. If he hadn't just transferred the property, he would have had to sell the stock, get the cash, and then pay her off. So yes, in an intangible sense, he has gotten the value of the investment.
    - Carrying it out further, if he had paid her with cash, she would've gone out and bought the Dupont stock.
  - Davis then has a gain, under §1001 of $7k. His amount realized is the money plus the property received. He got no cash or property literally. However, he got a release of claims against him. Generally, §1001's definition of amount realized is under inclusive and the court will fix it. Here, the amount realized is the value of the wife's claims. This is an exchange. So we can assume that the value of the wife's claim is equal to the FMV of the stock. This was an arm's length negotiation, so the court is comfortable with this assumption. It was essentially a sale.
  - So yes, Davis realized his gain in the exchange where he received a release of his wife's claims.
  - The problem with realizing a gain is that it contradicts what happens in community property states. The division of community property in a divorce is a nontaxable event. But in a separate property state, under Davis, it's a taxable event. Now, if Mr. and Mrs. Davis had been joint tenants or tenants in common, then it wouldn't have been a taxable event upon division of the stock.

b. Ex-Wife
  - Is the wife taxable? The court says the wife's basis is the FMV of the property received. So her basis would be $82k. The question of whether she would be taxed is not answered.
  - Wife takes a basis of FMV on date of receipt.

- But this is not a taxable event as to the wife. Why? If it's an exchange for Mr. Davis isn't it also an exchange on the opposite side, for Mrs. Davis? She seems to be exchanging her marital rights, so may she has gain to the value of her marital rights (she had no basis in her marital rights). But the court says no. Mrs. Davis is not taxed. Why?
  - This isn't like a market transaction for Mrs. Davis. Her marital rights have no value outside of Mr. Davis. No one else would have paid for these rights. Thus, it's not a sale. What is it?
  - Damages. Pre-no fault divorces, the husband's payment to the wife can be seen as damages. He's liable under state family law. So for damages, the Raytheon rule governs. Ask in lieu of what were damages awarded?
    a. His help around the house, and with the kids, loss of consortium: This is non-taxable imputed income.
    b. What she would get in inheritance/under his will if there was no divorce: This is also non-taxable income under §102 and the associated basis rule: §1014.
    c. His financial, in kind support – providing for her food, shelter, clothing, etc.: This is non-taxable as a gift. §102
    - Under the facts of this case, it is clear Mr. Davis is paying damages for a and b in the form of the stock. There was a separate provision for support payments for her in kind support.
  - So under Raytheon, Mrs. Davis would not be taxed and she gets a FMV basis so she's never taxed!

C. Farid Es Sultaneh Case

1. General Rule

- Receiver of the property in the property settlement gets FMV of the property on the date of receipt.

2. Case
  - Kresge makes a pre-nup with future wife providing for a grant of Kresge stock if the marriage ends. The FMV of the stock on sale was $19/share. Mr. Kresge had a basis of 15 cents a share. The IRS argued that this was a gift and TP (Kresge's wife) should take the donor's basis of 15 cents a share, §1015. TP argued that she should take a basis of $10.67/share – the FMV of the stock on the date of receipt.
  - The IRS wanted an objective, bright line view, that was easy to administer. They wanted every transfer within a family to be a gift. But the court was unwilling to give the word "gift" more meaning than common usage would allow.
  - So the court ruled this was not a gift for tax purposes. As such §102 and §1015 do not apply. Rather, the court held, TP gets a FMV at the time of the gift, she's getting damages.

D. Court's Response §1041 – Nonrecognition – Tax Deferral

1. §1041

- §1041(a): Nonrecognition Rule: No gain or loss shall be recognized on a transfer of property from an individual to a spouse, or a former spouse if the transfer if incident to the divorce.
  - So under §1041(a), Davis would not pay tax on the appreciation in his stock. He had realized gain, but Congress says the gain was not recognized, so it would not be taxed.
  - Transferor is not taxed on the appreciation, but the transferee gets the transferor's basis. So this is tax deferral.
- §1041(b): The property shall be treated as acquired by the transferee by gift, and the basis of the transferee in the property shall be the adjusted basis of the transferor.
  - Under §1041 Mrs. Davis would take the basis of Mr. Davis, and Sultaneh would take her ex-husband's basis of 15 cents per share.
  - You take the donor's basis whether the property has appreciated or depreciated in relation to the donor's basis.
- So under §1041 you want to look at the tax brackets and give the appreciated property to whoever is in the lowest tax bracket, and give the depreciated property to the person in the highest tax bracket.

2. Theory Behind §1041

- This is a question of timing and rate transfer. With §1041 we are taxing the enrichment to the wrong person, and at the wrong rate. Recipient spouses tend to be the lower earner with a lower rate. So you get tax deferral and a rate reduction. Why?
- The IRS was getting whip-sawed. Husbands were not paying tax on the appreciation because it was counter-intuitive. They didn't realize they were supposed to. Husbands felt like they were getting ripped off, not like they were enriched. Congress did this because they decided it was better to get a little later than never.
- §1041 equalizes tax treatment of divorcing spouses in community and common law property states.

XVII. Tax Treatment of Alimony

Rule: In kind payments, property settlements: Use §1041.

Rule: Cash payments, use §71 and §215.

A. Generally

- Alimony: Periodic payments of spousal support (as opposed to property transfers).
- Under Raytheon, you would think the payee would not be taxed on alimony, as it's a substitute for tax free in kind support. §102. And that was originally the rule. Before Congress enacted §§71 and 215, the payor was taxed when earned and the payee excluded the alimony.
- In 1942 §§71 and 215 were enacted.

1. §71 and §215

- §71: Alimony is taxable to the recipient.
- §215: Alimony is deductible to the payor.
- The main problem with alimony taxation is defining and identifying alimony. For tax purposes, alimony is defined under §71(b) as:
  - a. Must be cash;
  - b. Must be received by a spouse under a divorce or separation instrument;
  - c. The divorce or separation instrument cannot designate such payment as a payment not includible in gross income;
  - d. The payee and payor spouses cannot be members of the same household at the time payments are made;
  - e. There can be no liability to make payments for any period after the death of the payee.
  - With these requirements, Congress is saying form over substance. A change from the prior rule.
  - Under §71(b)(1)(B), if you don't want the payment to be alimony, you can simply switch the tax treatment by saying in the divorce agreement that "this is not alimony." Then the Payor will get no deduction and the payee will exclude the payments. Like a gift.
    - So you need to see who's in the lower tax bracket and write the agreement in the most favorable way. Must take into account prospective tax situations when writing the agreement.
    - Fairness, economic neutrality, horizontal equity usually require that we unscramble transactions and see what in substance is happening. Unless Congress adopts a form over substance approach, courts will unscramble. But with §71(b) Congress adopted form over substance. Why? Easy administration. Disadvantage? Easy manipulation. However, the alimony recapture rule of §71(f) limits the extent that you can manipulate the system.
    - Child support can also be structured to be excluded by the payee.

2. Policy Behind This Reversal

- In 1942 the tax that used to soak the rich, became an indiscriminate tax on all. By shifting, the husband is only taxed on the portion he gets to keep. The tax liability is split between the two of them.
- The effect of this is the massive tax reduction, as the payee is generally at a much lower rate. The payee won't get alimony if she is more well off than the payor.
- The new statutes emphasize substance over form because a bright line rule was needed. Looking to the intent of the parties was too unwieldy.
  - In Bernatschke, the court looked to the intent of the parties and the underlying state law to determine if the transfer was alimony or a property settlement. This approach was unwieldy. So the court took a form over substance approach and established a bright line rule.
- This new method is favorable to divorced spouses.

3. Bernatschke

- Wife married her to the toilet fortune. They got divorced and he arranged for her to receive a $25,000 per year annuity. The IRS argued this was periodic support payments. Alimony. The TP argued that this was installment payments of a property settlement. In substance we had a two step transaction: A $650k cash property settlement (step 1), and then a purchase of annuity contract by the wife (step 2). The court looked to the intent of the parties and the underlying state law. The wife received what she would have received as inheritance if they were married when her ex-husband died. So the parties really did see this as a property settlement, and the court held it was a property settlement, not alimony. §71(b) now would see this as alimony in form, regardless of what it was in substance. It was just too unwieldy for the courts to have to look into the intent of the parties in each divorce.

XVIII. Business Deductions

A. Basic Considerations

Net Income = Gross income – Expenses of Producing Income (§§162, 212, 167) = Consumption (§262) + Change in Wealth (§§263, 263A).

- Money coming in is equal to money going out. We care about net income, not gross income. Gross income is the ultimate source of your enrichment, but to the extent you use gross income to produce your consumption income, it is not net income.
- All costs of producing income are deductible. Deduction provisions:
  a. §212: Deduction of investment related expenses;
  b. §162: Business related expense deduction;
  c. §167: Depreciation expenses; Corresponds to §263.
  d. §262: No deduction ever for personal, living, or family expenses – consumption;
  e. §263: Capital expenditures are non-deductible (deductible later, not now);
  f. §263A: Capital expenditures are non-deductible.
- There is competition between §162 and §263.

B. §162

1. Generally:
- §162 requires the expense be:
  a. Ordinary;
  b. Necessary;
  c. Paid or incurred during the taxable year;
  d. In carrying on any trade or business.
- The origin and character of the claim with respect to which an expense was incurred, rather than as potential consequences upon the fortunes of the TP, is the controlling basic test of whether the expense was business or personal within the meaning of §162(a).

2. Definition of Necessary (Welch)
- Necessary means appropriate and helpful (not necessary).
- What justifies this twisting of the language? Too much litigation would ensue as to what is necessary. Business judgments should be made by business men, not the courts and the IRS. If it was "necessary" courts and the IRS would be making constant business judgments, and that is not their specialty.

3. Definition of Ordinary (Welch)
- Ordinary means common in the business world, a regular occurrence in the business world.
- This is a relative, objective standard. A taxpayer specific standard would result in bizarre results. Mere repetition would make things ordinary. If you just started a business, nothing would be deductible, which would be silly.

4. Welch v. Helvering

a. Case
- Welch's business went under. He went to work on his own as an independent salesman for Kellogg. He used his commission from Kellogg to pay off debts of his old company that had been previously discharged. The case turns on the meaning of "ordinary and necessary" under §162.
- Welch's payments were found to be not ordinary. There were three possible reasons why it wasn't ordinary:
  i. TP failed to produce evidence that paying off debts of a bankrupt company are common the business world. Absent proof, not deductible under §162(a).
  ii. Expenditures were not made to maintain the business reputation, but to acquire or improve the business reputation. Under §263, this is a capital expenditure. This is like purchased goodwill. Under Raytheon, purchased goodwill is a capital expenditure.
  iii. Expenditures to maintain or improve personal reputation are not deductible under §262. This was a high officer of the bankrupt company, not just any employee. He wanted to save his own face.
- The court fails to say which of these three alternatives it's using. Courts, however, have long interpreted Welch to say that the real problem is ii. He was trying to buy a business reputation and business reputation is a capital expenditure.

5. Cost of Education
- Conceptually, the cost of a law school education is the same as Welch.

i. Some education is to keep you up to date, to keep your law license. This is skill maintenance that is a cost of producing your income, and is deductible under §162(a).
ii. Some education is the cost of acquiring those skills. You have to qualify to practice. This is the purchase of the ability to be lawyer. This is §263, not deductible. It's the cost of acquiring skills needed to be deductible over the next 30 or 40 years. It's a long lived, income producing asset.
    - In principle, the costs of acquiring the skills should be deductible over 30 or 40 years. It's a long lived, income producing asset.
iii. Some education is consumption. Such education is not deductible (i.e. you're a lawyer and you take a painting class). This is entertainment, personal expense.
- An undergraduate degree would most likely fall under option 2 or 3.
- The Code only recognizes options 1 and 3 for education. You can't capitalize your law education and deduct it under §263. Why? There is no depreciation deduction under §167. Depreciation under §167 is only for property – skills and knowledge aren't property.

6. Tellier Case
a. Rule: Origin of the Claim Test: Don't look to the consequences, look to the cause of the expense.
   Rule: There are no judicial exceptions to deductibility based on public policy, Congress has legislated those into §162.

b. Case
    - The cost of legal fees for defense of securities fraud was deducted by TP. TP claimed the cost was deductible under §162. The court agrees and says yes, they're deductible.
    - There was gross income derived from his fraudulent activity. The costs of producing the illegal income are deductible. The deduction provisions weren't designed to impose an additional punishment on illegal activity.
    - So §162, is the expense ordinary and necessary? The lower court argued that illegal activity is neither ordinary nor necessary. The Supreme Court disagreed. The defense expenses are appropriate and helpful, and ordinary in the business world.
    - But what about §262, was this a personal expense? Wasn't Tellier's primary motivation to keep his ass out of jail? Which would be a personal expense? The Court says no, don't look to the consequences, look to the cause of the expense. This is the Gilmore, origin of the claims test.

7. Public Policy Exceptions
    - Public policy exceptions are judicial exceptions to deductibility. A very narrow exception. What did Congress do?
    - Congress responded by legislating statutory public policy exceptions:
        - §162(c), (e), (f), (g), and §280(e) – drug dealing expenses not deductible.
    - Congress was saying we don't want any judge made exceptions (at least to §162). If Congress hasn't said anything, you can take the deduction.

8. Mazzei Case
a. Summary:
    - Mazzei who got swindled in what he thought was going to be a counterfeiting scheme, claimed a loss deduction under §165. Technically, Congress has given public policy exceptions to §162 only. They do not apply to a §165 loss. The Court reads in a public policy exception and denies the loss. The deduction was denied. The dissenting view was that Congress wanted no judge made exceptions to deductions. But that view didn't prevail.

C. §263
1. Generally
- §263 disallows deductions for capital expenditures.
- §263 capital expenditures make a buck over several years. So §263 addresses the timing issue of properly measuring enrichment.
- If the amount you pay produces income in future years, then you can't deduct the expense presently.
- The trick is to figure out a capital improvement vs. a presently deductible repair.
    - Improvements are an integral part of the property
    - Improvements are long-live assets
    - Improvements extend the economic useful life (NOT the physical useful life).

2. §263 Policy
   i. Saving, not disenrichment (these §263 expenses amount to an investment)
   ii. ROC Timing (See problem Set 6)

3. How to Obtain ROC under §263?
   i. Adjusted Basis Credit for Capital Expenditures: §1012, 1016(a)(1)
   ii. Depreciation: §§ 167, 168, 197
   Adjusted Basis Decrease: §1016(a)(2)
   iii. Sale or Disposition: §1001(a)
   iv. If Adjusted Basis > Amount Realized, then you take a Loss under §165.

- So whenever you determine that something must be capitalized, you get a corresponding basis increase of the cost value.
- If you buy a capital asset or improve a capital asset, you get an upward adjustment in your basis.
- Remember: Adjusted Basis = Running Tally of your Current Tax Paid Investment.

4. Mt. Morris Drive In

a. Case
   - This case addresses what is the meaning of capital expenditures under 263. There was a disagreement over whether a drain added to property is a "repair" under §162 and deductible, or an "improvement" which would be amortized as a capital expense.
   - Repairs vs. improvements are a hard factual question. Repairs are currently deductible, improvements are not.
   - The tax court said this is nondeductible because: (1) it is an integral part of drive-in construction; and (2) it is a long-lived, separate physical asset.
   - The dissent said this was a current business expense. The drain did not prolong the physical useful life of the drive in. But what you should focus on is the economic useful life, so this argument is flawed. If the TP didn't install the drain, the neighbors would have shut it down and vastly decreased the economic useful life of the property.
   - The dissent in the COA argued that the alternative was for the neighbors to be paid past, present, and future damages, which wouldn't be a permanent improvement. However, if the neighbors release future claims, then in substance you've sold an easement – which is a long lived property interest. So the dissent was wrong.
     - If it had been damages only for past and present damages, then maybe the dissent's argument would work.

D. §167 Depreciation

1. §167 Generally

- "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business or for the production of income."
- So, if property is subject to exhaustion, wear and tear, etc., we give you cost recovery year by year over the life of the property. Cost recovery through depreciation deductions over the period of use.
- Take stock, for example, you don't get a depreciation deduction for that, why? No need, you get back your tax paid investment tax free when you sell it. With other investment though, if they wear out through use, you won't be able to get back all of your tax paid investment when you sell it because it's not worth that much anymore.
- The depreciation deduction of §167 works in combination with §1001 to make sure you get your tax paid investment back.
- Now, as you get back your depreciation deductions, your basis if reduced.
   - So each year that you take a depreciation deduction, your basis is reduced according to §1016(a)(2).
   - When you sell for a gain or loss you use Amount Realized less Adjusted Basis (remaining unrecovered tax paid investment). If you have a loss you get a loss deduction under §165.

2. Idaho Power Case

a. Case

- Idaho Power owned some trucks that they used to build new distribution and transmission stations. They wanted to deduct the depreciation over the life of the truck – 10 years, under §167. The IRS said no, the cost of the trucks were part of the capitalized buildings and would have to be deducted over 30 years.

b. Why §263?

- Had the trucks been used to produce income for one year, i.e. for use in meter reading, it would be income depreciable under §167. However the trucks were used to build new, long lived property. So it is not property to deduct the cost now. The depreciation deduction became part of the capital expenditure, part of the cost basis for building the transmission stations.
- Taxable income is computed not he basis of taxable years §441. You must match year by year the expenses with the income it produces.
- If this was a scrambled transaction, say the trucks were used 40% in meter reading and 60% in building the new stations, then it would be 40% deductive under §167 and 60% capitalized under §263. Keep good records!

c. Policy Behind this Case:
- Horizontal Equity: Compare Idaho Power who builds its own stations with a company that pays an independent contractor. The contractor would have charged you for use of the trucks, which you would have added to your cost basis, so this result promotes horizontal equity.
- Economic Neutrality: Don't want to incent people to build things themselves over hiring contractors.

d. Congressional Priority:
- §161 states that "there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX."
- Part IX includes §263, so §263 trumps §167.

D. §262 Personal Consumption
1. §262 Generally
- "Except as otherwise provided in this chapter, no deduction shall be allowed for personal, living or family expenses."
  - But §63 gives a standard deduction and §151 gives the personal exemption deductions. These deductions for personal consumption are to ensure that some minimum level of consumption it tax free so that people can survive.
  - Although §262 says no consumption is deductible, some basic level of consumption is tax free. Historically §63 and §151 are kept at the poverty level.

2. Henry C. Smith Case
a Case Facts:
- Ms. Smith tried to deduct the cost of child care for her son. She argued that but for the work, she wouldn't have incurred the child care cost. So this cost was uniquely justified by her job.
- The court said no deduction. This was a preparatory expense, not "incurred in carrying on" a trade or business. §162 is not satisfied because she did not incur the expense while "carrying on" a trade or business. She was merely preparing for it.

b. Tax Policy
- As tax policy should be allow a deduction for child care to allow people to work? There a competing analogies:
- Compare TP working mom, is she more like:
  i. Working woman with no kids; or
  ii. Stay at home mom?
- If you compare TP to i, TP has the child care expenses because of the kids.
- But if you compare TP to ii, TP has the child care expenses because of working. In this latter case, it looks like the child care is a cost of earning the income.
- Which is more appropriate? You need a blanket, across the board rule, so which way would cause the least injustice? Which is more common?
- Wiedenbeck would argue that Smith as a matter of policy was wrong when decided but right today. Apparently today he thinks that the majority of women should be compared with the working woman with no kids.
- The tax rule is no deduction except what Congress authorizes in the child tax credit in §21.

3. Pevsner Case
a. Facts:
- TP claims a §162 deduction for the amount she paid for Yves St. Laurent clothes that she had to wear because she worked in the boutique. A matter of statutory interpretation, she should qualify for a §162 deduction because she was in effect acting as a model. She incurred the expense in carrying on a trade or business. However she doesn't get the deduction because of the personal consumption aspect to it, the §262 aspect.

- §262 uses an objective point of view. Objective standards are necessary in order for the rule to administrable. Clothing, other than uniforms, are consumption expenses and not deductible.

4. Travel Expenses: Problem Set 10

a. Cost of travel to and from work.
   - Under §162 this is not a business expense. The cost of traveling to and from work is not a cost incurred form "carrying on" a trade or business. This is preparation to work, putting yourself in the position to work.
   - What if TP talks on a cell phone the whole way to the office? The cell phone expense is now incurred in "carrying on" a trade or business, but the car ride is still coincidental. TP is driving to work "while carrying on" not in carrying on.
   - Competing Analogies: If you look at where you work as fixed, rather than where you live, it seems to be a personal choice where you live and thus your commute is a matter of personal consumption. But if you look at where you live as fixed and where you work as a matter of choice, then your commute would more accurately be an expense incurred in carrying on a trade or business.
   - Congress had to pick the most fair way to think about it, and they chose where you work to be fixed. But this isn't really always fair. In many cases where you live is fixed, but we have adopted the rule that your commute is not deductible.

b. The cost of travel, meals and lodging when litigation takes TP to DC for a week?
   - §162(a) traveling expenses, while away from home in pursuit of a trade or business are deductible. So we would allow a deduction for transportation and lodging while in DC and a 50% deduction for food.
   - The cost of lodging is a duplicate cost: TP is already paying for a house in her hometown, so it should be deductible. This is cost arises exclusively because of conducting a trade or business in another city.
   - What about meals? Not duplication. You always have to eat. But eating out is more expensive than cooking your own food at home. This is constrained consumption. As a matter of tax policy, the correct rule would be to allow a deduction for how much TP spends on food on the road less how must she would ordinarily spend.
     - But Congress gives everyone a deduction for 50% of the amount of food cost. This is an administrable rule that recognizes that at least some of the cost is core consumption. §162(a)(2).

c. The cost of travel and meals when litigation takes her to DC for a day?
   - §162(a)(2) seems to cover the meals, but the Supreme Court has said that §162 covers meals only when you are out of town overnight.
   - The cost of travel is deductible. The cost of travel between two work locations would be exclusively work related and thus deductible under §162(a). So it's silly to make you go to work, then leave for your business out of town just to get the deduction. It's all deductible under §162(a).

d. The cost of travel, meals and lodging when working at the client's headquarters in DC for eight months?
   - §162 says that if you work out of town for more than one year, retrospectively, you cannot deduct. If you stayed for less than one year, you can deduct. This is a bright line, administrable rule.
   - At some point when you work out of town for a long time you will stop duplicating you housing and just move. But where is that point? Congress enacted what it did because it's administrable.

E. Gilmore:

- Tax Treatment of the Payor of Damages: Deductible as a Business Expense?

Origin of the Claims Rule: Look to the causation of the damages: Did the payment of damages grow out of personal or business/investment activities.

- Don't look to the consequences of paying the damages.