I. **Introduction**  
- Statutory Interpretation and Tax Policy  
  o **General Interpretation Guidelines:**  
    - For definitions of terms look:  
      - § 7701 for general definitions  
      - Same section in which the term appears or related sections  
      - Common Usage = Past history/custom → trying to carry out the command of the sovereign. If Congress didn’t define it, then it probably meant its commands to be understood the way people normally understand it.  
      - Unintended ambiguity = definition of these terms should change with the times  
  - Legislative History  
  - Policy – what is the legislative purpose of the statute?  
    - Note statutory prescription, in written English, of simple arithmetic operations (e.g., excess of $X$ over $Y$ [-], sum of [+], bears the same ratio as)  
    - ALWAYS check ALL statutory cross references  
  o **Tax Policy**  
    - **REVENUE GENERATION**  
      - REVENUE EFFECT – Does the provision cause a gain or loss in tax receipts, and if so, how much?  
      - ADMINISTRATIVE CONVENIENCE – Does the provision permit uniform, low-cost enforcement?  
        - Is the enrichment impossible or very difficult to place a value on? → Benaglia alternatives:  
          - No tax on meals and lodging – violates economic neutrality principles  
          - Expenses avoided = amount taxpayer claimed he would have paid to live elsewhere → fairest, but difficult to gather objective data  
          - Taxpayer’s subjective value → only way to truly discover taxpayer’s enrichment, but impossible to discern  
          - Cost to employer = wrong focus  
    - TAXPAYER COMPLIANCE – Does the provision minimize taxpayer dissatisfaction by limiting record-keeping and reporting costs, constraining administrative discretion, promoting simplicity, convenience in the timing of tax liabilities, and the appearance of fairness?  
    - **FAIRNESS**  
      - VERTICAL EQUITY – Does the provision maintain or promote differences in tax burdens between persons in
differing circumstances? There is consensus that a *regressive* income tax (i.e., an effective tax rate that decreases with increasing income) violates vertical equity; the view that justice demands a *progressive* income tax (i.e., an effective tax rate that increases as income increases) is widely held but not universally accepted (see section 1); some contend that a *proportional* income tax (a/k/a “flat tax”) is fairest.

- **HORIZONTAL EQUITY** – Does the provision maintain or promote substantial similarity of taxation among persons in substantially similar circumstances? In the context of the income tax, horizontal equity demands that two persons with the same *economic* income should pay the same tax, regardless of the *source* or *use* of that income. *(See section 61(a): “gross income means all income from whatever source derived”)*.

- **TRANSITIONAL EQUITY** – Does the provision, if new, contain adequate safeguards to protect reliance interests and prevent windfall gains and losses?

### ECONOMIC OBJECTIVES

- **ECONOMIC NEUTRALITY** (a/k/a/ “efficiency”) – Does the provision cause tax-induced changes in the utilization of economic resources, and if so, do these changes make the allocation of resources more or less like the allocation, which would prevail in a no-tax world? In the context of the income tax, concern for economic neutrality often manifests itself in measures to mitigate “capital lock-in” resulting from the realization requirement or “labor lock-in” resulting from the tax-free status of imputed income.

- **ECONOMIC GROWTH** – Does the provision promote (or retard) economic growth?

- **ECONOMIC STABILITY** – Does the provision ameliorate (or exacerbate) fluctuations in the business cycle? A tax provision, which bears harder during periods of rapid in the business cycle? A tax provision which bears harder during periods of rapid expansion can reduce inflationary pressure by taking purchasing power out of the economy, while rules that reduce tax burdens during recession tend to sustain economic activity by leaving more money in the private sector, thereby propping up spending. The progressive rate schedule is often said to have beneficial “automatic stabilizer” effects, because on average wages and other items of personal income increase during periods of economic growth, but decline during recessions.

**Scope of Code:**

- Every Individual = every human being, including babies, etc.  
  *(§6012(b)(2) – person with disability’s obligation to file a return)*
• “taxable income of every individual” = It’s the baby’s taxable income therefore she is responsible for the tax
  o The proper nexus is ownership – see state law concerning ownership.
• Exceptions = § 1(g) → “kiddie tax” = statutory limit on one’s ability to spread wealth to lower income bracket family members

  ▪ **Taxable income = gross income – deductions**
  ▪ Graduated Rates → Receiving overtime will push Joe into a higher tax bracket, but the higher rate will only be applicable to the money over the 36,900 (the $2000 of overtime money); Only applies to additional income
    • **Marginal Rates** = only applies to the money earned at the margins
    • **Progressive Rate Schedule** = What principle of fairness is reflected in the current version of IRC § 1? → as your taxable income increases, you pay a higher percentage of your total income to taxes
    • **Vertical Equity** = Individuals in substantially different circumstances should be treated differently by the law – total income is the relevant circumstance
      o Proportional tax system = flat rate, the more you make, the more you pay
        ▪ Inconsistent with vertical equity
      o Progressive tax system = rates increase with increase in tax base
        ▪ There are certain minimal income requirements for a decent standard of living and everything else is superfluous. It is patently unfair to tax people who are just squeaking by the same as people who have an obscene amount of discretionary income. Discretionary income is not the same as discretionary income.
      o Regressive tax system = rates decrease with increase in tax base → dollar obligation goes up with increasing income just not as fast
    • **Economic Neutrality** = In a free market economy the tax law should interfere as little as possible with economic decision-making, and so it should not create incentives to change what people consume, how they invest or how much they work
      o Income tax violates this principle because it discourages overtime work and skews decisions between leisure and work, favoring leisure
  ▪ Scope of Corporate Income Tax → § 11 and not § 1 b/c U City is not an “individual”
• Is a City a “corporation?” ➔ Statutory macro-definitions, § 7701 = “includes associations, joint-stock companies, and insurance companies.”
  o Common usage/general understanding = probably not association
  o 7701(c) – “includes” = “shall not be deemed to exclude other things otherwise within the meaning of the term defined”
    ▪ “corporations” may mean something in addition to the defined terms
  o “corporations” includes these things that people don’t normally think of as corporations in addition to the things that are incorporated
    ▪ Unincorporated business entities are subject to taxation as well
  o Municipal Corporations = Corporations for tax purposes
• §115 – gross income does not include (1) income derived from any public utility or the exercise of any essential governmental function….
  o Certain income of state and local government does not count as income for tax purposes.
    ▪ Congress would not have needed to pass this exception to certain types of income if state and local government was immune to tax liability entirely.
  o Is keeping excess funds in a local bank an “essential governmental function?”
    ▪ “Essential” = very important
    ▪ Sound money management = a very important governmental function
      ▪ Incentive to manage money soundly
  o Are profits earned from running a bank an “essential governmental function?”
    ▪ Cities don’t typically take over banks so it’s not an essential governmental function
    ▪ What if Congress made a mistake and unintentionally left an ambiguity? – understanding of these terms should change with the times
    ▪ Court will decide the meaning based on legislative history or policy
  o Policy: this is a non-interference provision with a federalism purpose – federal government should not be involved in municipal affairs
International Scope → § 61(a) – all income from whatever source derived = source of the income is irrelevant
- “Every individual” is not conditioned on residence – If you are a resident of the US you pay US Income Taxes
- “Every individual” is not conditioned on citizenship – If you are a citizen of the US you pay US Income Taxes
- Source → Nonresident alien = non-resident of US, non-US citizen may still have to pay taxes
  - Are subject to the US federal income tax!
  - Everyone in the world is subject to it!!!
  - Even non-resident aliens can be taxed → § 2(d) – French citizen residing in France and receives dividends from GM – Yes she pays 30% tax and it is subtracted from the total amount she receives before she ever gets it → § 871 a = Gross Withholding Tax = tax of 30% of the amount received from sources within the US by a non-resident alien if it is… dividends… but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the US
    - What result if income that’s “not effectively connected” with US trade or business is also:
      - Not from US source; or
      - Not one of the types specified in 871(a)(1)?
    - No US tax liability → § 2(d)
- § 877 – Suppose you are a descendant of John D. Rockefeller and you have an annual income of $20 mil. from investment portfolio.
  - Suppose that the top rate in section 1 is 50% or more and applies to TI over $200K.
  - If any of the purposes for losing citizenship was the avoidance of taxes, your tax rate is from § 1.
  - Presumption that you left to avoid taxes.
- French citizen and resident collecting dividends from a Panamanian corporation – No taxes maybe depending on where the corporation derives its income
  - §7701(a)(5) → Foreign = a corporation or partnership which is not domestic
  - 861(a)(2)(B) – Dividends from a foreign corporation are considered Gross Income from...
Overview of Tax Computation

Gross Receipts
- Loan Proceeds
- Cost of Goods Sold (if any)

Gross Income (§ 61)
- Exclusions (§§ 101-39)
Gross Income (§ 61: "as otherwise provided")
- Nonitemized Deductions
  Adjusted Gross Income (§ 62) (cf. accounting "net income")
- Itemized Deductions or the Standard Deduction (§ 63)
- Personal Exemptions (§ 151) (compare § 262)

Taxable Income (§ 63) (the tax base)

X Rates
Tax Imposed (§ 1 or § 3)
- Credits (§§ 21-52)
Tax Due

NOTES:

1 Gross receipts here means all items of value received, whether money, property or services.

2 Loan proceeds (the principal amount received on disbursement of the loan) are not income, for reasons to be explored later.

3 Gross income does not include the full amount of sale proceeds, but only "Gains derived from dealings in property," § 61(a)(3), and Gain = Amount Realized - Adjusted Basis (§ 1001), where Adjusted Basis is (roughly speaking) the cost of goods sold (§§ 1011-12).

4 Nonitemized deductions are the deductions listed in section 62(a). See § 63(d)(1). Unlike the itemized deductions, there is no substitute flat allowance or other alternative to claiming the actual amount expended for these items (compare the standard deduction, infra). Although it is hard to find a common theme among the nonitemized deductions, it is important to remember that essentially all business expenses (except unreimbursed expenses of employees) are nonitemized deductions. Other nonitemized deductions include losses from the sale or exchange of property and alimony payments.

5 In general, itemized deductions include most investment and personal (i.e., consumption-related) deductions. The standard deduction is a flat allowance for the personal deductions of taxpayers who do not itemize.
- Value of a deduction = Not a direct subtraction from tax liability
  o Reduces taxable income (reduction in tax base)
o How much of a reduction depends on your overall taxable income and your tax rate

o 2 categories of deductions:
  ▪ Costs of producing income. E.g., lawyer collects $10K fee from client, pays rent, salary of secretary/paralegal, Lexis subscription…. See IRC 162(a). Goal = fairness.
    • The obligation to the government should be based on increase in resources available for personal consumption or saving
    • Net enrichment = ability to pay
  ▪ Personal deductions (e.g., mortgage interest, property taxes, charitable contributions) – mostly itemized deductions
    • Encourage home ownership, charitable contributions, property purchases
    • Social policies to encourage certain behavior are the point of these deductions

- Exclusion is functionally equivalent to a nonitemized deduction b/c there is no alternative standard exclusion
- Credits are subtracted from the actual tax due → $1 dollar of a credit saves the tax payer $1

  o Deductions are better for higher income people than lower income people
    ▪ Lower income people lose much more consumption opportunity than higher income people
  o Credits are not affected by rate = both lower income and higher income people lose the same amount of consumption opportunity through credits
  o Revenue loss of charitable contribution deduction nearly equal to revenue loss that would be caused by a 25% tax credit → why doesn’t Congress make charitable contributions a credit?
    ▪ Treasury indifferent b/c both are equally costly
    ▪ Congress is influenced by higher income individuals and higher income individuals prefer deductions for their charity as opposed to credits
    ▪ If you are at a marginal tax bracket below the % credit, you prefer the credit
    ▪ Charitable organizations prefer whichever method gets them more money
      • Higher income individuals give to more elitist causes – higher education, medical research, etc.
      • Lower income individuals give to churches, etc.
    ▪ Congress prefers keeping the elitists happy – either it prefers higher income individuals or it prefers the organizations higher income individuals give to
      • Society is better off because of the elitist causes
      • Congress people are high income
      • Congress people get money from higher individuals
    ▪ Congress has no single intent → over 500 Congress people never act with a single intent!
II. **Scope of Gross Income = “all income from whatever source derived”; income = enrichment, accession to wealth**

- Old Colony Trust Co. v. Commissioner → Company agreed to pay all income taxes due on president’s salary. Salary was almost $1 mil. in 1918, and employer paid $681K taxes directly to IRS.
  - IRS’s argument = payment of the tax was consideration of the employee’s services – tax payment was part of the employee’s compensation
    - Tax payment = indirect benefit to employee
    - § 61 Gross Income includes “compensation for services”
  - **Constructive Receipt = “The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.”**
    - Indirect benefit = income
    - **Economically equivalent transactions must be taxed the same** – the tax paid by the company would have had the same affect if it was paid directly to the employee
    - **Substance over form = Ignore mere formal distinctions; only consider differences of substance. Enrichment = relevant inquiry**
      - Merely formal distinctions between 1-step and 2-step transaction.
        - If the employee won, then all employees would ask their employer’s to pay their taxes for them. Those who didn’t have bargaining power would be screwed – NOT FAIR
        - No economic neutrality – the tax system should distort as little as possible individual decision making – undermined by allowing employers to pay taxes for employees
          - Leisure is not taxed so people will want to engage in more leisure to avoid paying higher taxes → Leisure is taxed – sales taxes?
          - First judicial recognition of this theory.
  - **Income is not purely receipts, but receipt plus benefit (gain or enrichment)**
- In-Kind and Imputed Income → § 61 makes no distinction between cash and in-kind
  - Nontransferable, non-employee benefits
    - Reginald Turner → As prize for correctly answering radio quiz taxpayer won 2 first-class cruise tickets from NYC to Buenos Aires; traded for 4 tourist-class tickets from NYC to Rio, and took the whole family in 1948.
      - FMV as objective measure of minimum enrichment
        - Fair market value = Price at which property would change hands between willing buyer and willing seller, neither under any compulsion to buy or sell, both
having reasonable knowledge of relevant facts. Treas. Reg. § 20.2031-1(b)

- Taxpayer specific.

- **Expenses Avoided + Subjective value (?)** = the money he did not spend on he and his family’s living expenses at home + the pleasure of the trip (saved the money he would have spent on a regular vacation)

- **EMPLOYMENT-RELATED EXCLUSIONS – enrichment without tax**
  - Haverly v. US → High school principal gets free textbook samples as part of his job. He did not report them as income, but gave to school library and claimed $400 charitable contribution deduction → $400 = income b/c he took the deduction
  - Valuation of in-kind income (current law)
    - **Transferable Goods/Services:** Net FMV = Amount this taxpayer could realize on sale less costs of disposition (may be much less than retail price)
    - **Nontransferable Goods/Services**
      - Perhaps expenses avoided (see Benaglia dissent and, perhaps Turner) = unusual case
      - **Employer-provided benefits:**
        - Meals and lodging - IRC § 119 (successor to Benaglia)
        - Other Goods/Services – IRC § 132 and other exclusions
  - **§ 119 =** Meals and Lodging → constrained consumption

- **Convenience of the Employer Doctrine**
  - 1937 – **Benaglia** interpretation of section 61: In-kind benefits provided for the convenience of the employer are not income to the employee. *Convenience of the employer* = “solely because he could not otherwise perform the services required of him” = benefit absolutely essential = provided as a matter of business necessity. → hotel manager gets free meals and lodging for he and wife tax free
  - **Section 119** enacted to codify treatment of employer-provided meals and lodging. Section 119(b)(1) added to negate the limiting interpretation (the “intended as compensation” approach).
  - **Treas. Reg. § 1.119-1** interprets section 119 requirements for exclusion, as follows:
    - (i) **Convenience of employer** = meals (or lodging?) “furnished for a substantial noncompensatory business reason of the employer.” Reg. § 1.119-1(a)(2).
      - Not business necessity but business convenience (helpful)
Congress intended to make a more stringent requirement for lodging, so it had to start out with a less stringent requirement for meals to avoid making the statute redundant.

- (ii) Business premises of employer = place of employment of the employee. Reg. § 1.119-1(c)(1).
  - Not where the employer works but where the employee works
- (iii) Required to accept lodging as condition of employment = “required . . . in order to enable him to properly perform duties of his employment.” Reg. § 1.119-1(b).
  - Not the employee has to do it in order to get the job but the lodging is necessary for the employee to do the employee’s job correctly.

1977 – Supreme Court (Kowalski) interprets section 119 requirements for exclusion as follows: cop’s business premises?:

- (i) Convenience of employer = business necessity, because Congress intended to adopt the Benaglia term of art.
- (ii) Business premises = not statewide as the dissent suggests, perhaps the business premises of cop is the office in which they work.
- (iii) Condition of employment = employee must accept – cannot be given a choice
  - Makes statute redundant

1978 – Congress responds to Kowalski by adding section 119(b)(2) and (3). Congress’ response to Kowalski is that you’re crazy: “cash” and “in kind” is a formalistic distinction that is wrong:

- (b)(3) = $ that is withheld from salary to pay for meals is excluded from income
- The effective date Congress prescribed for section 119(b)(2) and (3) is retroactive to 1954, the date of enactment of section 119 in its original form to prove that the intent of 119 in its entirety included (b) from the beginning.
- 119(b)(3) does NOT apply to lodging, but perhaps lodging should be treated the same to take into account policy reasons behind taxation

- Sibla v. Commissioner: LA firefighters required to eat at station house, contribute to common mess fund,
purchased and prepared food themselves, and collected costs.”

- § 162(a) – common mess fund is deductible as a business expense.
- 119(b)(3) as it applies to Sibla → “fixed charge” – this is not a “fixed charge” b/c the price of the food changes every week.
  - Fire department required the firefighters to eat together to fight discrimination – business necessity (constrained consumption?)
  - Dissent: No constrained consumption b/c the employees not the employer decided what they were going to spend their money on – not that different from a family situation
  - Maybe this is not a good case for exclusion
    - 119(b)(4) → if the majority of employees qualify for the meals exclusion, then all the employees qualify for the exclusion

- § 107 = living expenses for a minister of the gospel – No Convenience of the Employer!
  - No, the rental value is not included as TP’s gross income. Enacted in 1921, way before the convenience of the employer test. More liberal approach b/c some ministers won’t meet the 119 demands and those people would rail against the tax system from the pulpit.
  - Assume now that the parishioners pay TP an annual rental allowance of $12,000, which TP uses to rent a small farm. The parish serves a rural community and TP uses the farmhouse as her residence. → The term at issue is “to the extent used by him to rent or provide a home.” Will the small farm qualify as a home? Any money that is not used “(1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home” will most likely be included as gross income. Also, “the portion of the rental allowance expended in connection with the farm or business property shall not be excluded from his gross income.” No distinction between cash and in kind. Difference between a house and a home = home includes furnishings, etc., whereas house is the empty building.
  - 107(2) says that the rental allowance will be excluded “to the extent such allowance does not exceed the fair
rental value of the home.” The issue is whether paying off the mortgage faster means exceeding the “fair rental value of the home.” Also, there is some question about whether paying off a mortgage qualifies as “rental” of a home – this distinction is not important b/c the statute says “to rent or PROVIDE a home [this year].”

- TP must be given the rental stipend as “remuneration for services which are ordinarily the duties of a minister of the gospel.” These services include “performance of sacerdotal functions, the conduct of religious worship, the administration and maintenance of religious organizations and their integral agencies, and the performance of teaching and administrative duties at theological seminaries.” I doubt the validity of the Universal Laugh Church. I would also object that $25,000 exceeds the “fair rental value of the home.”

- § 132 = Fringe Benefits
  - § 132(a) = 7 different exclusions
    - 132(e) → de minimis fringe = any property or service the value of which is... so small as to make accounting for it unreasonable or administratively impracticable.
      - 132(e)(2) → subsidized cafeterias are de minimis as long as they are on or near the business premises and as long as the company is not making a profit
  - VP “forced” to test drive vehicle every month – must he report income? 132(a)(5) = qualified transportation fringe? No. 132(a)(1) = no-additional-cost service? No, b/c the employer incurs substantial additional cost by not being able to sell the car new and b/c TP does not work for the line of business for which the product is normally offered in the course of business.
  - Business line limitation. 132(a)(3) = working condition fringe? If the employee had paid for it out of one’s own pocket, then the payment would have been deductible – No b/c commuting costs are not deductible, but driving 1000 miles a month is not enrichment but a pure business expense? Actually it is mixed business and personal. 61(a)(1) includes “fringe benefits” as income. 132(h)(2) says any use by spouse or dependent child of the employee counts as use by the employee.
    - Primary Purpose Test = not excluded b/c a lot of the driving will be for personal enrichment not for work.
    - Product testing as working condition fringe
      - Conditions according to committee reports:
• Consumer testing and evaluation an ordinary and necessary business expense of the employer;
• Business reasons necessitate that testing and evaluation be performed off-premises by employees;
• Item is furnished to employee for the purpose of testing;
• Made available for no longer than necessary to test and return at completion of testing period;
• Constrained Consumption = Employer imposes limitations on employee’s use that significantly reduce value of any personal benefits to employee; AND
  - Employer limits employee’s ability to select models or varieties for testing;
  - Employer allows employees to purchase or lease same type of item to limit personal use by family; AND
  - Employer requires that members of employee’s family generally cannot use the item.
• Employee must submit detailed reports on the testing.
  - The proper measure of income = FMV – what TP paid for the benefit.
• Did Congress intend cash or cash equivalents to be excluded under 132(e)? – Yes b/c “any property or service” → gift certificates may be excludable
• The value of the service would have to be “so small as to make accounting for it unreasonable or administratively impracticable” after taking into account the frequency with which similar fringes are provided – per employee for vertical equity purposes - by the employer to the employer’s employees. If the benefit is small enough, we’re not going to bother with it. If the cost of figuring out how many employees took advantage of it is so high as to make it stupid to try to figure it out, then it’s de minimis. It seems like if people are taking advantage of the fringe 4 to 5 times a week and spending up to $50 per dinner. That does not seem like a de minimis expense, but this doesn’t matter. If looked at on a per employee basis, then it’s not income. Fact that the firm has to account for the meals and cab fair to bill it to the client.
indicates that accounting for the expense is administratively practicable. The cab fare home on the other hand is probably small enough to count as a de minimis expense and therefore is not taxable. The purpose of the section is to encourage employees to seek employment in cities with limited parking and to encourage the use of public transportation. It also encourages employers to have restaurants on the premises.

- 132(c) = Qualified employee discount – applies to property or services
  - Services = only up to 20% is tax free
  - Property = only up to gross profit percentage
    - Gross profit percentage = average mark-up of the item the employee buys if the employer categorizes the items differently; in the hypothetical, the mark-up = 15%
    - Only the “highly compensated employee” is hurt by the sanction of 132(j).
    - “Highly Compensated Employee” = 5% owner or is paid $80,000 (adjusted for inflation) or above
    - Discriminatory? = “available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees.”
      - Amount of benefit = substantially the same
      - Who qualifies for the benefit = group of employees which is defined under a reasonable classification that does not favor the highly compensated
      - Group = how long you worked there; however, reality is that “highly compensated employees” are benefited at the expense of lower paid employees
        - Applying Old Colony’s substance over form argument, the IRS wins and the discount is discriminatory

- 132(j) nondiscrimination rule applies in only a few circumstances: no additional cost service, qualified employee discount and (e)(2) company cafeteria
  - Does NOT apply to de minimis fringes
• Does NOT apply to working condition fringe – 1 step transaction must be taxed the same as an economically equivalent 2 step transaction
• Applies to big ticket cost items – no-additional-cost service = free flights to airline employees and their families
• Business reason for (a)(1) & (2) benefits?  makes employees happy without much cost (additional compensation); low cost advertising; familiarity with the product may create better sales people
• Who sets company’s compensation policy?  makes the owners and highly compensated employees
  ▪ Anti-abuse rule = Congress is trying to prevent unfair additional compensation to the people responsible for awarding the additional compensation
• Perceptions/appearances of fairness of the system as a whole = Taxpayer compliance concern, see CB 67
  ▪ If lower class thinks tax system is designed to protect the rich, lower class may stop paying taxes.
• Tax incentive for broad distribution of benefit  makes cross-subsidy = covert redistribution from the highly compensated to the lower compensated, but depends on the 1 to 1 ratio between highly compensated employees and lower compensated employees.  This is not the case, so cross-subsidy doesn’t work.
  ▪ Hidden bribe.

• IMPUTED INCOME
  ▪ Consumer Durables = no tax for benefit of owning a home
    • Buying a home and living in it does not count as income for tax purposes b/c homebuyer does not receive anything.
    • Buying bonds and receiving dividends does count as income for tax purposes.
    • Encourages home ownership, and discourages renting  makes greater stability in the community, Congress is bribed by home builders, unfortunately encourages urban sprawl
    • Equalize them by either taxing both or neither:
      • Tax the imputed rental value of TP1’s use of the home
      • Treats housing like anything else and discourages over-investing on housing
    • Give TP2 a deduction on her rent.
      • Increases everyone to over-invest in housing
  ▪ Services provided by the spouse who stays at home does not count as income for the working spouse.
• The working spouse would have to make enough to cover the cost of the services lost by the spouse working.
• Message = stay at home, don’t work
• Equalize by:
  o Tax the stay at home spouse for the value of the services produced.
  o Give the working spouse a deduction for the services they have to buy.
    ▪ Would encourage both spouses working.
    ▪ § 21 Child Care Credit

- Mowing Neighbor’s Yard example
• What about week two, when neighbor mows both yards? Then the TP has enrichment. This is compensation for services, with services.
  o Treas. Reg. 1.61-1(d)(1) : If services are paid for in property, the fair market value of the property taken in payment must be included in income as compensations.
  o If services are paid for in exchange for other services, the FMV of such other services taken in part is taxable… (barter transactions are taxable)
• Exchange of identical services = taxed; self-performance of services = not taxed

- Compensatory Receipts
  o RETURN OF CAPITAL = You get back the amount you have invested tax free; in other words, conversion of property into cash does not count as income to the extent the cash received is not more than what you paid
    • Consider example in Raytheon: TP owns building purchased for $5,000; current FMV = $50,000. If fire destroys top three floors of this 5-story building and TP recovers $30,000 damages from negligent tenant, what is the tax treatment?
      • Assume FMV of remaining building (two stories, if not rebuilt), is $20,000.
      • Tax of the same amount – just different timing:

<table>
<thead>
<tr>
<th>Method</th>
<th>Taxation of Recovery</th>
<th>Taxation of Later Sale Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROC Last</td>
<td>$30K (entire amount)</td>
<td>$5K Return of Capital (ROC)</td>
</tr>
<tr>
<td>ROC Pro-Rata (Partial Sale)</td>
<td>$27K (30K – 60% x 5K)</td>
<td>$2K ROC</td>
</tr>
<tr>
<td>ROC First</td>
<td>$25K (30K – 5K ROC)</td>
<td>0 ROC</td>
</tr>
<tr>
<td>Compare § 1033 (Non-recognition)</td>
<td>0</td>
<td>Sale proceeds less $5K ROC + $30K???</td>
</tr>
</tbody>
</table>

- Only if you put
the $ back into the building

- **TAX TREATMENT OF DAMAGES**
  - Edward H. Clark → TP had lawyer prepare 1932 tax return, but lawyer’s error caused $33K underpayment. Liability would’ve been $20K less if TP & spouse had filed separate returns. Lawyer paid TP $20K compensation.
    - TP is going to be in the same position he would’ve been in had the lawyer not made a mistake – it’s a wash
      - TP not enriched by 3rd party satisfaction of liability
    - Raytheon Prod. Co. v. Com’r → Raytheon alleged anticompetitive actions by RCA destroyed its rectifier tube business, including goodwill. RCA settled antitrust action for $350K. Not a penny changed hands between the parties because of the counterclaim, but the substance of the transaction is what matters.
      - **Raytheon Replacement Rule = “The question to be asked is ‘In lieu of what were the damages awarded?’”** (CB 83, 2nd ¶)
        - Depends on practical reality, substance-over-form.
        - Inherently factual inquiry – comes from the complaint in this case, but not always and focuses on the fact that the business was destroyed (just like selling the business)
      - Court says **damages for lost profits are income**:
        - 2 step transaction (RCA sells tubes to customers; RCA turns over ill-gotten gains to Raytheon) economically equivalent to the one step transaction (Raytheon’s sales of tubes to customers)
        - “Since the profits would be taxable income, the proceeds of litigation which are their substitute are taxable in like manner.” (CB 83) = Substance over form (Old Colony)
      - But court says that treatment is different where damages are **compensation for injury to goodwill** = return of capital, and is not taxable.
        - “Compensation for the loss of Raytheon’s goodwill in excess of its cost is gross income....”
        - **Damages from anti-trust violation = involuntary sale in essence**
          - Income = sales price – costs of making the tubes → 61(a)(3) = income is “gains derived from dealings in property”
            - 1001 → Gains = amount realized – adjusted basis
Amount realized = money received + FMV of any property received = total sales proceeds

Adjusted basis = basis under 1012 adjusted under 1016
  1012 → Basis = costs

Compare negligent damage to taxicab. Recovery will include both cost of repairs to taxi, the income-producing asset, and lost fares while cab is in the shop – that is, lost profits.
  ▪ Repair to the cab = involuntary partial sale that does not count as gross income
  ▪ Lost fares = lost profits count as gross income
  ▪ Same analysis if goodwill damaged but not destroyed? – Not really b/c it is a psychological benefit and is very difficult to repair and to prove reliably the extent of harm to the goodwill.

Raytheon pays tax on entire recovery b/c costs of constructing goodwill = 0
  ▪ Difference between purchasing goodwill (basis = cost of purchase) and constructing it (basis = 0)

Damages received for loss of reputation, emotional distress, loss of consortium (non-pecuniary injuries) should not be considered income because these things would be considered imputed income and would not have been taxed. Damages received for costs incurred in preparation for the wedding including money spent on invitations, flowers, reception space rental, food, etc. (pecuniary injuries) should not be considered income. However, any punitive damages will probably be considered a gain and consequently income.

§ 104(a)(2) = Damages for injuries or sickness are not income
  • The last sentences of 104(a) says “emotional distress shall not be treated as a physical injury or physical sickness,” but compensation for medical expenses directly attributable to emotional distress should not count as income. It seems like damages for pain and suffering would constitute “emotional distress” and be included in income to the extent that those damages are not compensation for medical expenses attributable to pain and suffering. However, damages for lost wages and lost earning capacity seem like “any damages… received… on account of personal physical injuries,” and consequently not income. Judicial economy – if Raytheon applies, you would have to try the case again basically to determine how much is punitive and how much is pain and suffering. Because most state courts have special verdicts for
punitive damages, you probably won’t have to go to court. If there is a settlement, you would have to go to court to figure it out.

- **Punitive Damages = income**
  - Glenshaw Glass
    - Congress in § 61 intended to exert “the full measure of its taxing power.” What’s the measure? – As broad as Congress’ Constitutional power to tax.
      - “Intention of Congress to tax all gains except those specifically exempted.” CB 86.
  - **Windfalls = income**
    - **HEALTH CARE COSTS = 106, 105, 213(d)(1)(D), 104(a)(3), 213(a)**
      - 3 ways to finance health care costs, in order favored by tax code:
        - Employer-provided group health insurance plans (ER-Provided) → encourages people to get a job w/ insurance
        - Pay for their health care expenses out of salary, savings or other resources as they are incurred (i.e., self-insurance) → encourages private pay
        - Individual health insurance policies paid for individually (EE-Purchased)

<table>
<thead>
<tr>
<th>Funding Method</th>
<th>Premiums</th>
<th>Proceeds</th>
</tr>
</thead>
<tbody>
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<td>ER-Provided Coverage</td>
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<td>EE-Purchased Insurance</td>
<td>Ltd. Dedn, § 213(d)(1)(D) – non-deductible 7.5% of AGI floor &amp; it’s itemized (it + other deductions must exceed standard deduction)</td>
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</tr>
<tr>
<td>EE Self-Insurance</td>
<td>N/A</td>
<td>Ltd Dedn, § 213(a) – non-deductible 7.5% of AGI floor &amp; it’s itemized (it + other deductions must exceed standard deduction)</td>
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</tbody>
</table>

- Ignoring limits of section 213, all amounts actually expended for medical care = tax free!
- Proceeds of PI tort claim excluded by 104(a)(2)
- 106, 105(a), 213(d)(1)(D), 104(a)(3) = Health-related expenses that do not satisfy the statutory definition of “medical care” (e.g., most cosmetic surgery costs) = disability insurance too
  - Speaking generally, one end of the transaction or the other is subject to tax.
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- Employer Cost Shifting would hurt employee’s tax status without **cafeteria plans and flexible spending arrangements**
  - Employers respond to escalating cost of health insurance by shifting more of the cost to employees, via increasing insurance “deductibles” and co-pays, and requiring employees to pay part of premiums.
  - See § 125, **“cafeteria plan” rules**, Treas. Reg. § 1.125-1 → employee gets a choice about which benefits to accept; result = **employee contribution is excludable**
    - Mere option of taking cash and then using it to buy your own health care would not otherwise be considered employer-provided healthcare premiums that are excluded from income.
  - Out-of-pocket expenses may be reimbursed through health care spending account, which is deemed to be additional employer-provided insurance. See flexible spending arrangements, Prop. Reg. § 1.125-2, Q&A-7.

- **Deduction for self-employed.** IRC § 162(l). Compare § 106(a), GI of “employee.” [tax expenditure = $3.6 million]

- **Health savings accounts.** IRC §§ 223, 62(a)(19). Compare § 213(a), (d)(1)(D). [tax expenditure = $0.4 million] Contributions into the account are deductible, no tax on interest gained from account, and no tax to take money out as long as it’s used for medical purposes.
  - Incentive for people to go uninsured? Not completely, just uninsured for all but the catastrophic costs.
  - High deductible health insurance covers only catastrophic risks → much cheaper


### III. Timing of Income = § 441(a) = “Taxable income shall be computed on the basis of the taxpayer’s taxable year.” → NOT transactional accounting

- Burnet v. Sanford & Brooks → Dredging company incurs $176K operating losses performing contract w/ U.S. to dredge Delaware River. Stops work in 1915. Sues in 1916 for breach of warranty of character of material to be dredged – you lied when you said it was sand b/c it turned out to be granite, so you owe us. Wins suit; U.S. appeals; S.Ct. affirms in 1920; Damages includable in Gross Income for 1916 when claim of right developed.
  - **Distinguish 3 meanings of term “loss”:**

  - Damages = compensation for services and consequently income
  - Distinguish 3 meanings of term “loss”:
- **Net operating loss** = spend more to do the work than you are being paid for the work – Eg. Burnet v. Sanford & Brooks
  - Negative profit (§ 172(c));
- **Loss on sale of property** = sell stock for less money than you paid for it
  - Negative gain (def’n § 1001(a); defined, §§ 165, 1211);
- **Casualty loss** = tornado comes through and destroys your rental house; resulting from damage or destruction of property usually as a result of natural causes
  - Negative windfall (§ 165(c)(3))
- 16th Amendment = exception to the apportionment requirement for income taxes → tax on a no-profit transaction is not a tax on income as it is meant in the 16th Amendment!
  - Purpose of 16th Amendment was to provide gov’t with reliable revenue source, and practical administration demands annual accounting → NOT true, purpose of 16th Amendment was to have a fair income tax system!
  - Annual accounting was prevailing practice at time of ratification → despite the fact that it leads to unfairness when transaction spans multiple years
    - Relevant to intent of the framers.

- Congressional response = § 172, net operating loss deduction. – apply excess deductions of previous years to the year in which the $ comes in or in the 2 prior years.
  - 172(d)(4) = excess deductions are only excess **business** deductions
- Dobson v. Commissioner → 1929 – TP bought 300 shares of National City Bank stock; 1930 – sold 100 shares, loss of $42K; 1931 – sold 100 shares, loss of $28K; 1936 – sued issuer for securities fraud; 1939 – settled for $45K, none reported as income.
  - Losses are typically deductible – 165(a) → loss = negative gain; reflects decrease in resources
    - Disenriched to the extent you lose on a sale of an item you paid more for than you received by selling
  - Loss deduction allowed because you didn’t get all your investment back → disenrichment. If later you do recover the investment via damages, settlement, or voluntary repayment from seller, then money was not lost & earlier deduction was erroneous.
  - **Tax Benefit Rule (TBR)**= So, in retrospect, earlier deduction was in error (no disenrichment if loss is reimbursed). Include recovery in income (even though it is a return of excessive purchase price) in order to offset prior erroneous deduction. This is the inclusionary aspect of the tax benefit rule, and you should see that it’s simply an **error correction mechanism**.
    - In light of ultimate recovery no disenrichment, deduction still error. However, it was, in effect, harmless error, so inclusion is not required. This is the exclusionary side of the tax benefit rule (exemplified in
Dobson). Really just means, do not apply inclusionary tax benefit rule
= NO TAX BENEFIT RULE

- **Annuities**
  - Issue is not how much tax IRS will take, but when the IRS will take it – no certain answer, but a variety of plausible responses.
    - Problem = money is fungible, so you can’t tell which dollars that you got represent the ones you spent to receive them.
    - **ROC first** = let’s make sure you really are enriched before we tax you
    - **ROC last** = everything you get out of it is gain, so we’re going to wait to give you the tax benefit until the end.
    - **Pro-Rata ROC** = compromise; fixed proportion of every payment is tax free
    - **Back-Load ROC** = Annuity is in substance a loan of $3790 to insurance company, which debtor promises to repay in 5 equal annual installments, with 10% compound interest. How much of each payment is interest? Principal?
      - Year 1 interest = $3790 x 10% = $379 \rightarrow $621 reduces principal.
      - Year 2 interest = ($3790 - $621) x 10% = $317 \rightarrow $683 reduces principal.
      - Year 3 interest = ($3169 - $683) x 10% = $249 \rightarrow $751 reduces principal.
      - ETC.
      - Mortgage amortization, in effect.
    - **Front-Load ROC** = reverse of Back-Load ROC; Annuity can be restructured as five separate $1000 endowment contracts, maturing 1, 2, 3, 4 and 5 years after purchase. If annuitant bought one such contract from five different insurers, and each was willing to repay the loan with 10% compound interest, how much would each company charge as premium?
      - Insurance Co. 1 has use of money for one year; $1000 discounted at 10% for one year = $1000/1.1 = $909 premium
      - Insurance Co. 2 has use of money for two years; $1000 discounted at 10% for two years = $1000/(1.1)(1.1) = $826
      - Insurance Co. 3 has use of money for three years; $1000 discounted at 10% for three years = $1000(1.1)(1.1)(1.1) = $751.
      - ETC.
| Pro-Rata ROC | 758 | 758 | 758 | 758 | 3790 | Endowment Ks
| Back-Load ROC | 621 | 683 | 751 | 826 | 909 | 3790 |
| ROC Last | 0 | 790 | 1000 | 1000 | 1000 | 3790 |

|  |  |  |  |  |  | Annuity § 72; Straight Line Depreciation
|  |  |  |  |  |  | Mortgage Amortization
|  |  |  |  |  |  | Sale of Nondepreciable Prop = §1001 G/L

- **Life Annuity = § 72**
  - Immediate life annuity = payments start immediately
  - 72(a) = express statutory inclusion of all money received under the annuity
  - 72(b)(1) = express statutory exclusion
    - **Exclusion ratio = investment in K/expected return**
      - 72(c)(1) - Investment in K = aggregate amount of premiums or other consideration paid for the contract minus anything you’ve already gotten back tax free
        - $50K
      - 72(c)(3) – Expected Return = if the expected return under the K, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary or the aggregate of the amounts receivable under the contract as an annuity
        - Actuarial tables = life expectancy tables
        - Treas. Reg. § 1.72-9
        - $5000/year x 16 years = $80,000
      - Exclusion Ratio = $50K/$80K = 62.5%
        - $3125 of each $5000 annual payment is tax-free
        - ROC
    - If TP dies @ age 84?
      - 72(b)(3) = the amount of such unrecovered investment shall be allowed to the person entitled to such payments for the taxable year
  - **Deferred Annuities** → Retirees buy annuity contracts because the concern is that they are going to outlive their savings, whereas annuities pay guaranteed (insurance element – insurance against living too long)
    - Deferred Annuities do not start until age 95, until that time, the deferred annuity holder is receiving interest
      - 72(e) = amounts not received as an annuity
    - Now 72(e)(2) says all money received before annuity begins will be allocable to income to the extent that the amount does
not exceed cash value over the investment in the $K = \text{ROC}$

- Last
  - **Life insurance** = 101(a)(1) = **Exclusion** of proceeds of life insurance policies across the board; 264(a)(1) = **No deduction** for premiums on any life insurance policy
    - **Term Insurance** = Insurance for a fixed amount of time; if the insurance holder lives past the fixed amount of time, then the policy holder loses the money. Paying premium to ensure a payout if insurance holder dies within the stated term of the contract.
    - **Whole Life Insurance** = multi-year (usually 20-40 years) policy that pays a constant death benefit if the insured dies before policy maturity date, and at maturity the insured (although still living) is paid an amount equal to the death benefit. Annual premium is fixed amount → highest premium for comparable amount of term insurance
      - Current tax treatment: Premiums nondeductible, proceeds on death tax free by § 101(a).
      - What is tax treatment if policy surrendered for cash value (either at maturity or before)?
        - 72(e)(1)(A) – applies to whole life insurance policy that pays out before death of insured
        - 72(e)(5)(A) – **amount shall be included in gross income**, but only to the extent it exceeds the investment in the $K$
          - (e)(6) – investment in $K = \text{aggregate premiums paid for } K \rightarrow \text{does not take into account the amount of each premium used to pay for the term insurance.}$
          - Allows deduction of amounts spent on term insurance! Systematically understates investment income.
      - If you are terminally ill and you cash your policy out early, the proceeds are excluded → 101(g)
      - **Viatical settlement** = sale of your life insurance policy before death when death is near 101(g)(2)
        - Proceeds of purchase are treated as excludable under 101.
        - 101(a)(2) → purchaser of life insurance policy is taxed
    - **Tax Deferral!**

- **Realization and Recognition**
  - In order to completely determine the tax consequences of a sale or other disposition of property, you need to answer five questions: (i) How much gain or loss is **realized**?; (ii) How much of the realized gain or loss is **recognized**?; (iii) What is the **basis** of any property received in the transaction?; (iv) If any loss is **recognized**, is it **deductible**?; and (v) Is any recognized gain or loss a **capital gain or loss**?
REALIZATION = realization event = severance from risk of underlying transaction not physical severance

- **Constructive receipt doctrine** = Congress can tax you even if you don’t receive income as long as you could have received it by asking for it. Treas. Reg. § 1.451-2
- **Unrealized appreciation** (increases in market value of property before sale) → if Congress can’t tax #1, the increase in stock value attributable to earned corporate profits invested in business → a fortiiori **mere market value increases not taxable.**

- Eisner v. Macomber (S. Ct. 1920) → Mrs. Macomber owned 2200 shares of stock of Standard Oil of California. In 1916 corporation declared 50% stock dividend, and TP received additional 1100 shares. Standard Oil issued the dividend to prove to their shareholders that it was an extremely profitable corporation (they were profitable because of the automobile).

  - Range of options in disposition of corporate profits
    - 1. Retain and reinvest in business.
    - 2. Retain, reinvest, issue stock dividend.
    - 3. Issue optional stock or cash dividend.
    - 4. Distribute as cash dividend.
    - In order of decreasing corporate control or increasing shareholder control
      - Dissent = Even undistributed corporate profits may be taxed currently to shareholders, if Congress says so, just as undistributed partnership profits are taxed to partners.
      - Majority = **Substance-over-form** proves options 1 & 2 are equivalent; Congress cannot tax shareholders on option 1 b/c, unlike (general) partner, shareholder has no right to withdraw profit share, hence cannot “derive” gain from capital.

  - Income means “gain derived from capital, from labor, or from both combined” (CB 210) - Shareholder derives nothing from corporation by virtue of a stock dividend (CB 212-13)
  - Stock dividend works no change of substance in relationship between corporation and its shareholders. Difference between 1 and 2 is purely formal.

- Congressional Responses to Macomber:
  - **Realization**, in general: §§ 61(a)(3) (“derived from”), 1001(a) (“sale or other disposition”).
  - **Stock Dividends**: §305(a) = Stock dividends are **excluded** from income, except as otherwise provided in this section.
    - 305(b)(1) if the distribution is, at the **election of any of the shareholders** payable as either stock or property.
• **305(b)(2)** If the distribution has the result of the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.

• **307(a)** = basis allocation (by FMV per Treas. Reg. § 1.307-1(a))

### Tax Policy & Realization

- **Pro:** Administrative convenience – subjectivity in fair market value of real estate or privately held business is erased by sale. With a sale comes the objected market value of the real estate or privately held businesses; Taxpayer compliance – taxpayer may not have the cash without liquidation to pay the increase in property value.

- **Con:** Horizontal Equity – person whose investment in corporation that doesn’t pay dividends receives an accession to wealth just as the person who invests in a corporation that pays dividends, but only the one who receives dividends will pay taxes on the property; Economic Neutrality – people will be more likely to invest in growth (retain earnings without stock or cash dividends) corporations than corporations that give dividends; Vertical Equity – only the wealthy can afford to own stock, private businesses or real estate, therefore only the wealthy receive deferral

### Helvering v. Bruun

In 1915 TP leased land and building for 99 years. In 1929 tenant demolished building and constructed new one. In 1933 lease forfeited for nonpayment of rent, TP took possession, got new building with FMV $51K > original structure.

- Holding = Value of building is taxable in the year of the lease termination → overturned by 109

- “[P]rofit realized from the completion of a transaction.” (CB 247) Means…? – Transaction that is complete = the lease. The lease was for a term of 99 years, but the lease ended early. The landlord didn’t expect to be able to lease until 2014, but that doesn’t matter because now he can lease the property out for a higher rate due to the improvement in land.

- Not physical severance that we care about; it’s severance from the risk of the underlying transaction that we care about. The risk of the transaction is severed when the lease expires.
  - Cash dividend is taxable b/c it is no longer subject to the risk of the underlying transaction when it is released from the control of the corporate board.
  - Main Question: Does the taxpayer have control?

### Congressional Reaction = § 109 = gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property
attributable to buildings erected or other improvements made by the lessee.

- We have the Constitutional power to tax the landlord, but we are not going to exercise that power.
- Tax deferral not forgiveness ⇒ 1019 no increase in basis for improvements made by lessee, when landlord sells building the improvements will not be subtracted as basis

### Losses ⇒ Cottage Savings Ass’n v. Commissioner ⇒ In 1980 Cottage Savings swapped 90% participation interests in 252 mortgages with four other S&Ls. Face amount of interests given up was $6.9 mil., but at time of exchange they were worth only $4.5 mil. TP claimed $2.4 million loss deduction. - § 165

- Exchange is realization event only if there is a **material difference in properties exchanged**.
  - CB 261 “material difference” = “legal entitlements that are different in kind or extent.” CB 262 “legally distinct entitlements.”
- Authority for definition = S Ct. precedent CB 260-61 ⇒ stock in same corporation in same proportion is materially different if the corporation incorporates in a different state (changing state of incorporation = realization event)
  - I.R.C. § 1001(a) “Sale or other disposition” language – “other disposition” not defined, but left to courts. Why? – Origin of realization doctrine is found in the Constitution in Eisner v. Macomber
  - Second authority was structure of the Code – distinction between realization and recognition, esp. § 1031 ⇒ If an exchange of any two investments that happen to be substantially the same is not considered realized, then 1031 is unnecessary.
- Realization applies to both gains and losses ⇒ realization is a predicate for both positive and negative tax considerations.
- Realization based on administrative convenience – court may not recognize realization as in the Constitution anymore

### 165(a) = “There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.” – **sustained** = **realized**

- (c) = limits – losses only deductible if:
  - incurred **in a trade or business**
  - incurred **in any transaction entered into for profit, though not connected with a trade or business**
  - if such losses **arise from casualty** (fire, flood, etc.)

- **RECOGNITION**
  - 1001(c) = all realized gain is recognized unless otherwise not recognized in the code
• **Non-recognition** = exception to the principal of taxation on realized income; Congress may have the power to tax because there has been a realization, but Congress can go further and grant you an exemption from paying tax on realized gain
  - **Basis** = with every non-recognition rule comes an applicable basis rule
• **Even exchange hypothesis** = reasonable people will not exchange one thing for something else of lesser value; owner of GM stock worth 110K will not exchange that stock for GE stock worth less than 110K and vice-versa
• **§ 1031 Exchanges of Like-Kind Real Property** = in substance, you are selling your property to the other guy and buying the other guy’s property
  - **Conditions on 1031 nonrecognition**:
    - Property used in trade or business or for investment (property from which the owner intended to derive income)
    - Exchanged
      - “Exchanged” = substantially simultaneous transfers? – Not according to the courts, but yes according to 1031(a)(3) = consummate the swap of deeds within 6 months
      - Starker was really exchanging land for a K option to receive land later.
    - Solely for property of “like kind” – no definition in § 1031 or § 7701
      - § 1031(h)(1) = real property in the US and real property not in the US is NOT like kind → real property within the US is of like kind with other real property within the US
      - Treas. Reg. §1.1031-1(b) = improved real estate and unimproved real estate are like kind
    - Held for use in trade or business or production of income
      - Land cannot be inventory; cannot be held to subdivide and sell
• **1031(d) – basis of the property received = basis of the property given up**
  - AB Property Received = AB Property Given Up – Cash Received + Recognized Gain – Recognized Loss
• **Policy for non-recognition**:
  - Administrative Convenience = Avoid valuation controversies; FMV inherently disputable (example of wait-and-see approach).
  - Horizontal Equity = Unfair to tax if no substantial change in nature of investment, even if there has been a
technical realization event. Compare swap of similar property with continued holding of property – unrealized gains get continued tax deferral.

- **Taxpayer Compliance** = If exchange, TP may not have cash with which to pay tax = liquidity concern. Convenience in timing of liability important to TP perception of fairness. Partial explanation – but popular explanation

- **Economic Neutrality** = Avoid capital lock-in effect. Suppose TP owns land that has doubled in value, from $50K to $100K, which TP expects to continue to appreciate at 10% annually. TP has located another parcel that he believes will appreciate at 11% annual rate – should he sell? If realized gain taxed at 20% rate, will have only $90K to reinvest after tax.
  - **Capital lock-in** = Recognition encourages lock-in. The more appreciation TP has in the property, the more likely TP is to stay locked in.

- **Not Solely Like-Kind = Property + Boot**
  - Recognize the gain up to the boot.
  - Tax deferral to the extent the proceeds are invested in the same type of property (real). To the extent taxpayers bail out of the type of property, Congress will tax taxpayers.
  - Basis Rule = 1031(d) – Complex b/c there is more than one piece of property involved in this exchange.
    - First sentence prescribes total basis of all property (other than money) received:
      - AB Property Rec’d = AB Property Given Up – Cash Rec’d + Recognized Gain – Recognized loss
    - Second sentence prescribes allocation of that total AB among multiple properties:
      - “Boot” always assigned AB = FMV
      - Remainder of AB assigned to non-recognition (“like kind”) property
        - Full basis is FMV of land
    - Test correctness of basis computation by making sure that a sale of the new land would result in a gain of zero.

- **1031(c) = no loss is recognized until sale**
- 2 items of personal property = like kind when:
  - Treas. Reg. § 1.1031(a)-2(b), depreciable tangible personalty like kind if in same asset or product class.
on U.S. $20 gold pieces and S.A. Krugerrands – not “like kind” b/c gold coins for gold coins is purely the formal description for what happened, but in substance, the U.S. gold coins’ values is determined by the fact that they are collector’s items, but the Krugerrands were essentially gold bullion.

- **1033 Involuntary Conversions** = can apply to cash sale and reinvestment; can apply to personal consumption property = house, car, etc.
  - 1033(a)(1) = conversion into similar property – if City took over property by eminent domain and paid for it with similar property
  - 1033(a)(2) = conversion into money or property not similar to the property converted – gain recognized but only to the extent the amount realized exceeds the cost of such other property or stock
    - “other property” = replacement property
  - Timeliness of replacement. 1033(a)(2)(B)
    - Beginning of replacement period = “Earliest date of the threat or imminence of requisition or condemnation of the converted property” → mere rumor is not good enough, but a news report confirmed by City officials is good enough
    - End of replacement period = 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized. – No gain in 1999 b/c amount realized = cost basis. Gain starts in 2001.
  - “Similar or related in service or use”
    - Common usage = golf course is not the same as residential area. Or is it?
    - “similar or related in service or use” standard of 1033 is much more stringent than “like kind” standard of 1031
      - Horizontal equity = Unfair to tax if no substantial change in nature of investment, even if there has been a technical realization event. Compare swap of similar property with continued holding of property – unrealized gains get continued tax deferral.
      - Administrative Convenience = Avoid valuation controversies; FMV inherently disputable (example of wait-and-see approach).
      - Taxpayer Compliance = If exchange, TP may not have cash with which to pay tax = liquidity concern. Convenience in timing of liability important to TP perception of fairness.
• 1033(g) = relaxes standards for land held for investment or business purposes
• 1033(b) = Tax deferral not forgiveness; Basis = Cost – Unrecognized gain
  ▪ 121(a) = exclusion from gross income for “gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer’s principal residence for periods aggregating 2 years or more.”
  • Tax deferral or tax forgiveness? → No basis rule so tax forgiveness – Why?
  • Buying votes from the middle class by not taxing the largest investment they have.

### Losses – Non-recognition
• Express statutory allowance and disallowance at the same time.
  - § 161 says that the disallowance rule takes precedence over the allowance.
• Sale to brother not deductible under § 267(a)(1)
  o However, if your brother sells for a loss, he gets to deduct his loss only.
  o Message = permanent forfeiture of the deduction.
    ▪ Policy = b/c of personal relationship you still have control over the stock; the sale is not real so you still have control or receive benefits from the property; concern about deductible sales being used to shift losses among family members to maximize tax savings. → get around this by selling to cousins or uncles, etc.
  o To the extent that the property recovers its value, the gain is only recognized to the extent the value exceeds the nondeductible loss. – deferral to the wrong person.
  o Sale to brother’s corporation = nondeductible b/c 267(c)(2) creates constructive ownership in you of your brother’s corporation.
  o Sale to brother’s wife is deductible
  o McWilliams v. Commissioner concluded that a similar sale by one spouse and purchase by the other constituted a 267 exchange and consequently the loss should not be deducted.
    ▪ →” no deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly…”
• “wash sale” provision of § 1091
  o 1091(d) = loss is deferred based on calculation of basis in new property.

- Loans and Offsetting Claims
  - **Loan proceeds are NOT income.**
    - Loan = conversion of credit (your reputation for repayment) into cash
    - Loan Tax Treatment = under income focus, loan proceeds are ignored b/c they are not enrichment, they are an obligation to repay; principal payments not deductible; debt forgiveness = income. Loans typically entail unconditional consensual obligation to repay in full.
  - Bond = long-term debt obligation; long-term loan transaction, where corporation or governmental unit, the bond “issuer,” is borrower, and initial purchasers are lenders.
    - Principal (amount loaned) repaid in lump sum at maturity. Periodic payments during term of the transaction are interest only.
    - Assume that I own 20-year, 10% $1K GM bond with 10 years to maturity. I’m going to sell it to you. How much will you pay?
      - First assume corporations are now issuing 10 year bonds of similar quality (risk) bearing 10% interest. You would pay the same for both bonds.
      - Now assume interest rates have dropped to 8%. Now you would pay more than $1000 for the bond. Premium for > market interest rate. Present value of future income stream (at 8% discount rate, compounded annually) = $1134.20.
      - Finally, if interest rates have risen to 12%? Now you would pay less than $1000 for the bond because you have the option of getting more for your money
  - **Discharge of Indebtedness = Gross Income ➔ 61(a)(12) = codification of Kirby Lumber**
    - US v. Kirby Lumber Co. ➔ Corporation sold $12 million in bonds in 1923. Later that year it bought back some of the bonds, paying $138K less for them than the amount company received on initial sale. $138K forgiveness of indebtedness = income.
    - Two different interpretations of the rationale behind Kirby Lumber:
      - **Enrichment rationale** = Income b/c enriched by discharge; some assets freed from claims of all creditors
      - **Recapture rationale** = Income b/c discharge proves that prior loan tax treatment was incorrect, so we impose a delayed tax on what was erroneously received tax free at time of original borrowing. That is, loan proceeds should not have been tax-free insofar as the offsetting liability was not later repaid (discharged).
        - The rule that there is income from discharge of indebtedness works as an error correction mechanism –
it can be viewed as extension of the inclusionary side of tax benefit rule.

- **Insolvency Exception** = Originally, courts said there is no discharge income if debtor is insolvent both before and after transaction (once known as the “rule of Lakeland Grocery”).
  - Even though liabilities reduced, none of debtor’s assets have been completely freed from claims of creditors. Issuer could just default and go bankrupt, and shareholders would have nothing left even after liabilities reduced in this manner → no enrichment.
  - Business behavior proves that there is value in liability reduction, even if still insolvent.

- **Congress’s view of insolvency exception = 108 = statutory exclusion from gross income if the discharge of liabilities occurs during bankruptcy or insolvency**
  - 108(a)(3) = “Lakeland Grocery” exception. If the reduction in liabilities gives you a positive net worth, then the discharge is income to the extent you receive positive net worth.
  - Deferral – 108(b) = Reduction in tax attributes dollar for dollar except in case of credits = deferral of taxation not forgiveness. When a corporation reduces its Net Operating Loss, it cannot carry forward the NOL as a deduction under § 172(a) in future years → larger future Taxable Income.
  - Other attribute reductions:
    - Basis – more taxes when you sell or less depreciation deduction
  - Congress sides with the Recapture rationale – you can slide on taxes now, while you’re insolvent, but as soon as you have money we’re getting it.
  - 108(e)(1) = no judicial insolvency exception – Lakeland Grocery exception is no more.
  - Does NOT apply to Kirby Lumber b/c TP was not in bankruptcy or insolvent

- Not every reduction in a stated liability is a discharge of indebtedness. Under recapture rationale, question is **whether debtor received anything of value tax-free that is not in fact repaid**.
  - Release from promise to give gift – debtor receives nothing of value from the discharge of indebtedness and therefore the release is not income.
  - Part (d): This is not discharge of indebtedness, it’s a dispute about the extent to which a debt really exists. Here, just an adjustment of the purchase price of legal services, not a bona fide liability followed by partial discharge. Note same result is now prescribed by statute where the liability arose.
Distinction between discharge of indebtedness (forgiveness) and satisfaction of indebtedness (payment). The debt is satisfied by the scrambled transaction, not discharged.

- Part (d) = payment in kind; in substance a sale of painting and use of proceeds to pay liability

Zarin → Compulsive gambler (Zarin) extended credit in 1980 of $3.4 mil. by casino (Resorts). Zarin loses full amount and fails to repay. When casino sues to collect, Zarin denies liability on ground that debt unenforceable. In 1981 Zarin pays Resorts $500K in full settlement.

- TP’s argument = **Purchase price adjustment**, akin to section 108(e)(5) = this shouldn’t be seen as a discharge of 3.4 mil debt, but as a compromise of the amount of the indebtedness.
  - Applies to the sales of property – chips are NOT property but a medium of exchange for services.
  - Requires bona fide dispute as to value received, like purchase of a car that turns out to be a lemon?

- 165(d) = “Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.”
  - “If we were effectively to allow petitioner to deduct the value of the lost chips from the value of the discharge debt, we would ignore annual accounting and undermine § 165(d) by in effect allowing gambling losses in excess of gambling winnings.”

- CONDITIONAL REPAYMENT OBLIGATIONS

  - **Claim of right doctrine** = If a taxpayer 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.

  - Different from normal loan b/c legal obligation to repay contingent on outcome of litigation. Offsetting claim not unconditional, and expected value of offsetting claim probably < amount of “loan” proceeds.

  - North American Oil Consol v. Burnet → U.S. contested TP’s right to exploit certain oil deposits. Profits earned by oil company in 1916 paid to receiver, but when TP won trial court decision in 1917, receiver paid over profits. U.S. appealed, and suit finally resolved (at Supreme Court level) in 1922. Court decides income in 1917 when the claim of right arose.

  - Section 451(a) says income properly reportable according to TP’s method of accounting, and 446(c) says either cash or accrual methods of accounting are permissible. But we don’t know whether this TP uses cash or accrual method!

    - 1916 is not the proper year under either of the methods – no receipt and no constructive receipt
(no right to demand payment) = no income under cash method; Income under accrual method when all events have occurred that fix right to receive payment and amount reasonably determinable. Amount clear, but ownership dispute = right to receive not fixed in 1916.

- **Cash receipts and disbursements** = report income when item received. § 451(a)
  - “constructive receipt” – Treas. Reg. § 1.451-2
    - don’t want to give taxpayer absolute discretion over when they are taxed by choosing not to withdraw right away
  - Report deduction when expense paid. Treas. Reg. § 1.446-1(c)(1)(i)

- **Accrual method:**
  - Income when all events have occurred that fix TP’s right to receive income (in future), and amount determinable with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii)
  - Deduction when all events have occurred which establish fact of liability, and determinable with reasonable accuracy, and economic performance occurs. § 461(h)

- US v. Lewis → if you have to pay back your claim of right income, then you can take a deduction
  - Employee received bonus of $22K in 1944, but employer asserts mistaken computation. Lewis repays $11K in 1946 pursuant to state court judgment.
  - Congress’s response = § 1341 = TPs equitable relief in cases like Lewis. Actually reduce taxes in year of repayment by amount of extra taxes paid when item received under claim of right.
    - Embezzlement cases = income in the year embezzled; no deduction when you pay it back either b/c embezzlement is not a business!

- James v. US → In earlier decision (Wilcox) Court held embezzler should get loan tax treatment b/c embezzled funds not held under any “claim of right.” At all times embezzler subject to an unconditional legal obligation to repay. Here, Court overrules.
  - Embezzlers are very infrequently caught and rarely repay the amount they embezzle. No legal contingency here, but “debt” is subject to extremely important factual contingencies – mentioned above.
  - Income tax treatment as a loan = inappropriate.
  - SCt was trapped by its own verbal formulation; focused on the legal liability to make restitution w/o stopping to
think that the purpose of the claim of right doctrine is to prevent tax deferral accorded loans when repayment is unlikely.

- McKinney v. US → embezzler reports embezzlement income as gross income, and pays back money and takes deduction. Invokes § 1341, but is unable to take the tax credit b/c he did not have an “unrestricted right” to the money. Also, claims § 172 net operating loss b/c his business is embezzling. Embezzlement can not be a business.

  - **Nonrecourse loans** = No personal obligation to pay, only risk of loss of property as collateral; lender limits itself to reclamation of collateral – TREATED LIKE ORDINARY LOANS DESPITE ABSENCE OF OBLIGATION TO REPAY
    - **Debt and basis** – in general
      - Cost basis included purchase money loans whether or not the borrower is personally liable for repayment (i.e. whether the loan is “recourse” or “nonrecourse”). Accordingly, adjusted basis, which is used for computing ROC (both gain and depreciation), also includes purchase money loans. (That is, basis = cost, regardless of how that cost is financed.)
      - Other borrowing secured by property does not directly affect the collateral’s basis. Of course, **if loan proceeds are used to improve property the additional investment (not the loan per se) is a capital expenditure that increases adjusted basis via section 1016(a)(1).**
      - Sale of property with a recourse loan; **tax treatment is the same whether the buyer pays the full FMV and seller pays off the mortgage or the buyer pays only the equity and takes subject to the mortgage (or assumes the personal liability)** b/c two transactions are economically equivalent under Old Colony Trust (3rd party paying off TP’s indebtedness is equivalent to TP paying off indebtedness himself)
        - Promise to pay off mortgage = property under 1001(b)

  - **Unscramble the scrambled transaction**
    - 1st – determine discharge of indebtedness = Principal value of loan – FMV of property
    - 2nd – determine gain from sale of property = Amount realized – adjusted basis
      - If recourse loan, 1 = regular income or loss; 2 = capital gain or loss
      - If non-recourse, 1 + 2 = regular income or loss

- **Nonrecourse (NR)** – some states’ anti-deficiency laws make all personal residence mortgages nonrecourse
  - Gain = increase in wealth (enrichment) due to increase in value (appreciation) of property, relative to owner’s tax-paid investment (adjusted basis)
Amount realized must be defined broadly to include entire proceeds of sale, whether received as cash, property, services, relief from personal liability, etc. – it is NOT so defined in the statute.

- Crane says **amount realized still must include outstanding principal balance of NR mortgage.**
  - To accurately determine amount realized and consequently gain, we must correctly measure full (i.e., unencumbered) FMV of property, so must “gross-up” proceeds received by amount of lien. → not about personal liability!
  - If the value of the collateral has fallen below the outstanding principal balance of the NR mortgage, then including full NR mortgage as “deemed” amount realized will actually mis-measure FMV of the property. → Holding of Tufts
  - Failure to properly unscramble a scrambled transaction into its component parts, namely: (1) property investment, and (2) loan transaction.

- Tufts → Mortgage principal value = $1.85M; Collateral FMV = $1.40M b/c of change in market conditions; Adjusted basis = $1.46; TP claims loss = $60K, excess of adjusted basis over FMV of collateral sold. IRS asserts gain = $390K, excess of mortgage balance over adjusted basis.
  - TP loses property – how is he enriched?!
  - Observe, however, that TP earlier received tax-free mortgage loan proceeds which, due to the subsequent drop in collateral value, he is not required to repay. Because TP was not taxed on nonrecourse loan proceeds, we must even up the score on disposition of collateral. → Kirby Lumber (income from the discharge of indebtedness)
  - Gain is not due to realty appreciation, it’s attributable to the discharge of the nonrecourse loan.
  - One can view a NR loan as advance agreement by lender to conditional discharge of indebtedness. Creditor says it won’t seek deficiency judgment should FMV of collateral < principal value of loan. Condition takes effect on transfer, so borrower has income from the discharge of indebtedness to the extent of the deficiency, even though borrower did not receive anything.
  - So **discharge income** = Principal Value of NR loan – FMV collateral = 1.85M – 1.40M = 450K, which is ordinary income.
o **Property income** → Foreclosure is a sale or exchange of the collateral, so Gain = FMV collateral – Adjusted Basis = 1.40M – 1.46M = -60K, which is Long Term Capital Loss.
  ▪ Discharge income + Property income = 390K? – NO; Should be 450K ordinary income + 60K of long term capital loss!
  ▪ Supreme Court held NR loan Principal Value included in amount realized, so 390K = capital gain. TP lost, but still came out ahead!!!

- **Congressional Response is to codify Tufts = 7701(g)**
- Recourse Loans on the other hand are always treated correctly – unscramble the scrambled transaction.

### IV. The Proper Taxpayer (Progression Problems)
- **Gifts and Kindred Items** = § 102(a) = “gross income does not include the value of property acquired by gift, bequest, devise or inheritance”; No definition of gift anywhere; § 102(c) = Employee gifts → any amount transferred by employer to or for the benefit of the employee is not excluded
  o Theoretical options:

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<td>Inclusion see § 61</td>
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<td>Combined Effect:</td>
<td>Tax donee only → promotes unjustified income shifting from usually wealthy donor to usually poor donee</td>
<td>Tax both donee and donor → however, donee would never voluntarily report without donor pointing out donee with deduction</td>
<td>Tax donor only = only practical way to do it and protects integrity of progressive rate structure</td>
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- **Congressional Approach**
  - **Caution:** This treatment strictly applies only to ordinary money gifts, not **gifts of property** (§1015), nor **charitable gifts** (§ 170)
- Irwin v. Gavit → In 1913 TP received income interest in testamentary trust that would terminate when his 6-year-old daughter reached age 21 or died. TP argued and lower courts held not taxable by § 102(a). Trust beneficiary’s interest received under will = bequest.
  - § 102(b)(1) = “Subsection (a) shall not exclude from gross income the income from any property referred to in subsection (a)”
• A gives stock to B, B later receives dividend. The dividend is subject to tax. – 102 does not exempt donee from all future tax on income from property.
• Assures that the income subsequently arising from an outright gift of property will be taxed.
  § 102(b)(2) – “Where the gift, bequest, devise, or inheritance is of income from property, the amount of such income is not excluded.” – Not in the statute when Irwin v. Gavit was decided.
• Assume TP with $1M in stocks makes a gift of shares to TPW for life with remainder to children. Had Mr. Gavit won, all income from stock during TPW’s lifetime would be tax exempt. That is, dissent’s view in Irwin v. Gavit would give TPs power to exempt from tax all income from investments by creating split interests in the property, because both LT and R receive interests by gift. TPs could repeat process indefinitely.
• Assures that the income portion of a gift of split interests in property will be taxed.

Life Tenant gets taxed on everything while Remainder gets property tax free.
• Contrast the treatment of the donee of Life Estate with the tax treatment of purchaser of Life Estate. Purchaser of Life Estate has a basis = cost, amount paid for the income interest, and is permitted to deduct that basis pro-rata over the estimated life expectancy of the measuring life (§ 167)
• § 273 = Purchaser of income interest gets investment back tax free b/c of depreciation deduction. However, donee of income interest does not get to take depreciation deduction.
  o 273 confirms and reinforces holding in Irwin v. Gavit, says that donee of Life Estate is not treated like purchaser, must pay tax on whole distribution. Not only not excludable as a gift, § 102(b)(2), also no offsetting amortization deduction, § 273.
• If Life Tenant sells interest – 1001(e) → basis = 0; so every penny is taxed b/c she is not allowed a basis to offset amount realized.
• If Remainder sells; property FMV = $100K; donor’s Adjusted Basis = $80K; Life Tenant interest to last 20 years. Principal Value Rem (at 5% discount rate) = $100K/(1.05)^20 = $37.7K
  o Remainder has a realized loss? 37.7K – 80K = - 42.3K
  Consider growth in value of remainder interest over time and corresponding diminution in value of term interest.
  Remainder gets full basis, but only when he comes into possession. Total basis is allocated between Life Tenant and Remainder
according to relative Principal Value at time of disposition, Remainder Adjusted Basis increases each year. Treas. Reg. §§ 1.1014-5, 1.1015-1(b). So, initial Adjusted Basis = ($80K/ (1.05)^20) = $30.2K \rightarrow $7.5K gain.

- If both life estate and remainder sell, then they both get to take their allocated basis in the property – 1001(e)(3)
  - R = $30.2K
  - LT = $49.8K

- Commissioner v. Early \rightarrow Elderly client signs over 70K shares stock worth $2.3 million to TP, an accountant. When client dies, gift challenged. TP settles by turning over stock and taking life income interest in trust (Life Estate Principal Value = $717K)
  - TP argues § 273 does not apply b/c they claim they did not “acquire by gift”; rather, purchased with property previously acquired by gift.
  - Claim depreciation deduction.
  - IRS says because transaction involved settlement of claims to property based upon disputed gift, the settlement payment (life income interest in trust), was acquired by gift.
  - Court says § 273 does apply b/c the interest was acquired by gift.
    - Here disputed entitlement, rather than distinct transactions.
    - Raytheon – determine tax on proceeds of lawsuit by looking “in lieu of what was received”

- Gifts of Appreciated Property \rightarrow Assume TP makes gift of stock, with FMV = $2K, to niece. TP’s cost basis = $1K. How much does niece exclude from GI under section 102(a), $1k or $2K.
  - “Value of property acquired by gift” \rightarrow FMV exclusion = $2K.
  - How do we treat TP upon making the gift – does he realize and pay tax on $1K appreciation? Does making a gift constitute a realization event for the donor?
  - Clearly, TP has bailed out of his stock investment – as to donor, transaction is over (Bruun). But has donor obtained value of the appreciation for his own use and enjoyment? Consider:
    - Code doesn’t treat gift as realization event, and donee excludes FMV under 102(a).
      - Deferral! § 1015 says niece receives $1K basis \rightarrow appreciation will be taxed later when donee sells.
      - The basis rule of 1015 is called a transferred basis ("carryover basis"), because the basis is transferred to donee along with the gift property. § 7701(a)(43).
        - Large loss of revenue b/c not taxing high income donor, but taxing lower income donee.

- Gifts in Kind
C buys stock for $1000; gives to D when worth $600. Tax consequences if D later sells for:

- $1400 \rightarrow \text{gain of } $400
- $500 \rightarrow \text{loss of } $100 \rightarrow \text{1015(a)} = “except that if such basis is greater than the FMV at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.”
  - Discourage shifting of losses to higher income family members.
  - Loss is forfeited entirely – disallowance of the loss. D should have bought it from C for $600, then C could have made a gift of the $. C gets the loss deduction and D gets cash and stock.
  - Never make gift of property declining in value – always sell it.
- $900 \rightarrow \text{Statute doesn’t work – neither gain nor loss!}

Property acquired from Decedents

- Under prevailing concept of realization and § 102(a), the tax treatment of both the decedent and the recipient of a bequest at the time of the transfer is exactly like treatment of gift – no tax on either party. But under § 1014(a), how do we treat recipient of bequest on later sale?
  - Basis = FMV at date of the decedent’s death \rightarrow \text{Tax forgiveness of any unrealized appreciation!}
  - Unrealized Loss = not deductible to either party
    - Sell all depreciated property b4 you die!
- Step up basis rule
- IRS applies statutory nonrecognition rules very strictly, b/c it’s not just a matter of timing and who has the use of the tax dollars. Rather, if we don’t tax appreciation now, it may escape tax entirely at death, under §1014.

Policy for 1014 FMV basis rule:

- Double Taxation = both income tax and estate tax.
  - Purpose of estate and gift taxation is to double tax.
- Liquidity = convenience in time of tax payment
  - Don’t want to force children to sell family farm or family business in order to raise money to pay income tax on appreciation. Transferred basis would solve.
- Capital Lock-in (after death v. before) – FMV basis to donee eliminates capital asset freeze-in effect.
  - Clearly, tendency to hold on to appreciated property to defer tax is eliminated if we forgive the tax, but that’s extreme. Rule of realization at death would solve this problem.
  - Causes capital lock-in b/c elderly are deterred from selling property that has appreciated.
- 1022 appears to be repeal of step-up basis rule and replacement with a carry-over tax similar to 1015.
  - Timed to coincide with repeal of Estate Tax.
  - 1022(b) Not really carry-over for anyone but the top 1% wealthiest people.

  o Commercial and Compensatory Gifts
  - Duberstein TP received Cadillac from a corporation after customer referral to business associate proved valuable. Corporate donor deducted Cadillac as business expense. Held not gift. But salary continuation for 10 months by church to president of RE operating company remanded for further findings of fact.
    - Gift = Whether transfer proceeds primarily from (1) constraining force of legal or moral obligation or anticipation of future benefit (not a gift), or (2) detached and disinterested generosity (gift). CB 173.
      - Look to primary motive of donor. Yet recipient may not even know what motivated employer or business associate to make payment.
      - Great weight accorded to fact-finder’s judgment – Primary motivation of transferor standard opens door to self-serving testimony credibility of witnesses important.
    - IRS’s position = Any transfer in business or employment context NOT gift. Objective standard, easily administered. – Rejected b/c doesn’t take into account fact that business associates can become friends.
  - US v. Kaiser strike benefits paid by a union to both members and nonmembers held to be a gift.
    - Amounts were paid in kind and payments were based on need (akin to welfare payments)
    - § 85 = Unemployment compensation included in Gross Income
      - Contingent deferred compensation
  - Congressional Response = 274(b) = No deduction for gifts if more than $25; where “gift” is defined as any item “excludible” NOT excluded by 102
    - Intended to assure that either transferor or transferee will have to pay tax on the item.
    - If employee excludes an item from income, employer is not precluded from deducting payment – However, if transferor wants the deduction, he will have to testify that primary purpose was NOT gift and consequently the item is NOT excludible
  - 102(c) = No such thing as an employer-employee gift!
    - Very close to IRS position in Duberstein!
    - Don’t forget De Minimis Fringe Benefit
Marriage and Divorce

- Property Settlement
  - § 71(b) and 215(b) = No deduction to transferor
  - Previously untaxed appreciation
    - Pre 1984 = Realization and taxable to transferor; tax-free to recipient with FMV basis (Farid-es-Sultaneh)
      - Even exchange hypothesis = what he got in return is equal to the amount he gave up. Applicable b/c the parties are engaging in arm’s length transaction
      - Mrs. Davis’ basis in the DuPont stock = FMV on receipt
    - Tax consequences of S.S. Kresge
      - Huge realized gain in 1924 when he bought ex-wife’s marital rights for the stock, per Davis
    - 1041 = Nonrecognition for transferor; tax-free to recipient via §§ 1041(b)(1) and 102(a), with carryover basis, § 1041(b)(2)
      - Basis = adjusted basis of transferor = carryover basis
      - Divorce planning implications of § 1041 – higher tax bracket person gets depreciated property; lower tax bracket person gets appreciated property
      - 1041 overrides realization in the Davis case, but in narrow context of divorce Davis still stands for general proposition that any transfer of property in settlement of divorce is a realization event.
      - 1041 does NOT apply to Sultaneh case because it was the result of a pre-nuptial agreement and not given to spouse or former spouse.

- Spousal Support = Alimony
  - Pre-1942: Gould v. Gould = tax-free to payee (consistent with Raytheon replacement rule)
    - Divorce reparation damages nontaxable whatever they redress
  - 1942-1984: “Alimony” = includible for tax purposes as periodic payments made in discharge of a marital obligation to support the spouse. Definition depends on both State law and intention of parties
    - Bernatschke v. US → Are payments under annuity Ks alimony to wife, or installment payment of property settlement?
      - Factors to determine that it was a property settlement:
        - Wife’s standard of living was drastically reduced → not maintenance of level of support to which she was accustomed. Also, amount of annuity fixed by reference to parties’ understanding of wife’s intestate share in estate.
  - Post 1984 § 71(b) = Tax definition of Alimony
• **Cash payments** if – cash versus kind; form over substance! – if not in cash then go to 1041
  o (A) payment is received under divorce decree
  o (B) separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction
    - **Taxpayer can elect which tax treatment they want.**
    - 1041(b)(2) \( \rightarrow \) carryover basis rule; determine who takes what property based on which tax bracket payor and payee fall into
  o (C) payments are not received while living in the same house
  o (D) no liability to make any such payment for any period after death of the payee spouse
• B/c it is formalistic, these rules are easily manipulated by adequate legal advice
• § 71 – Gross Income to the payee; § 215 - deduction for payor
  - 71(f) = **Recapture** rule was intended to distinguish periodic support payments (alimony, taxable to the recipient) from a cash property settlement paid in a lump sum or by installments over a brief period.
    - Cash payments made in lump sum or over brief period (substantial decline in payments over the first 3 years) – offsetting inclusion for payor and deduction for payee.
    - Evade recapture by planning for no substantial decline in payments over the first 3 years.
    - Always start by calculating the “excess payments for the 2nd post-separation year” because that quantity is needed to compute the “excess payments for the 1st post-separation year”
      o Excess payments for 2nd year = 2nd yr. payment – (3rd yr payment + 15K) = must be positive #, via 71(f)(4) definition.
      o Excess payments for 1st year = 1st yr. pmt – \{[(2nd yr pmt – 2nd yr excess + 3rd yr pmt)/2] +15K\}
      o Sum of excess for 1st yr and excess for 2nd yr = total excess
  o Child Support
    - Nondeductible by payor and not includible by payee, § 71(c)(1) – child support and alimony are malleable, § 71(c)(2)(B). Treas. Reg. § 1.71-1T, Q&A-18 = “clearly… associated” with a contingency relating to the child. – reverse of alimony; similar to a gift
    - 71(c) – **instrument must fix an amount of payments for child support or make the payments contingent on**
something relating to the child (such as attaining a specified age, marrying, dying, leaving school, etc.)

- Payor may get personal exemption deduction, §§ 152(c), 152(a) if s/he has custody of child for the greater portion of the year (unless the parties agree otherwise)

V. **Costs of Producing Income (Deductions)**

- **Business and Investment Expenses** = § 162(a) as “ordinary and necessary expenses paid or incurred... in carrying on” any trade or business?
  - Welch v. Helvering → TP was officer of corporation in grain business that went bankrupt in 1922. Later TP became commission grain merchant for Kellog Company, dealing with same suppliers he dealt with while working for his bankrupt company. From 1924-1928 TP voluntarily paid back > $46K debts of former employer.
    - **Necessary = appropriate and helpful.** CB 610
      - Otherwise tax code inhibits new forms of business interaction.
      - Wisest to leave business judgments to business people. IRS and courts should not sit as committee of review to determine how important business costs are, would inhibit innovation. As Cardozo observed, taxpayer thought repayment helpful, “and we should be slow to override his judgment.”
      - Business entertainment is deductible because, even though not essential, it’s helpful.
  - **Ordinary = common in business world**
    - Not taxpayer specific b/c all expenses of a new business would be non-deductible b/c it would be the first time those expenses would be done.
  - 3 possible reasons these are not business expenses:
    - TP failed to produce evidence that expenditures to maintain business reputation are common.
      - Payments should be deductible under § 162 but for failure of proof, like advertising or cost of maintaining goodwill.
    - Expenditures were not made to maintain business reputation, but to acquire or improve reputation.
      - **Disallowed by §263, as capital expenditure for purchased goodwill.** [Compare repair v. improvement problem]
        - Timing only! – may be deductible later upon sale or depreciation.
    - Expenditures made to maintain or improve personal reputation.
      - **Disallowed by § 262, as personal, living or family expense = permanent disallowance rule b/c it’s consumption.

- **Costs of Education**
3 potentially correct tax treatments:

- **Maintaining** existing income-producing skills (e.g., continuing professional education). Deductible under 162(a). Must:
  - Maintain or improve skills required in TP’s current employment, trade or business OR
  - Meet the express requirements imposed by the employer or by law for retaining TP’s current position or rate of pay

- **Purchase** of new skills that will produce income over many future years (e.g., professional degree). No deduction now, but depreciation or basis – 263(a) and 167(a).
  - Congress says NO Deduction ever!
  - No 1001 offset b/c you can’t sell skills!
  - No 167 depreciation b/c education is NOT property!

- **Entertainment or recreation** (e.g., arts and crafts courses at the community college). Never deductible 262(a) as a personal expense. If either:
  - The education is necessary to meet the initial minimum educational requirements for qualification in the TP’s employment (even if already employed) OR
  - The education qualifies the TP to enter into a new trade or business (even if TP does not do so)
  - § 274(h) = No deduction for costs of attending most conventions or seminars held outside US
  - § 274(m)(2) = No deduction of the costs of travel as a form of education

- Congress does NOT recognize category 2!!

- **Public Policy Disallowance**
  - Commissioner v. Tellier ➔ In 1956 TP, an investment banker, paid legal expenses of $23K in an unsuccessful defense of criminal charges of securities and mail fraud. TP claimed a deduction for that amount as a business expense under § 162(a). Commissioner and TC disallowed the deduction on the ground that it would violate public policy.
  - Recall that illegal income is gross income, because § 61 reaches all income “from whatever source derived”. And we saw in James (S.Ct. embezzlement case) that proceeds of illegal activity are not tax-free “loan proceeds.” Question in Tellier is does it work both ways?
  - There is no need to reach question of public policy disallowance unless the expense would otherwise be deductible under the general terms of § 162.
    - Government concedes and Court holds ordinary and necessary. CB 613-14.
    - Shouldn’t it be viewed as a personal expense to keep defendant out of jail?
Test of business v. personal legal expenses depends on origin rather than consequences of claim. Here charges arose out of business activity. Observe Court applies Gilmore origin-of-the-claim test. CB 613.

- Earlier lower court cases based disallowance on “ordinary and necessary” language, in effect holding that costs of illegal activities are (per se) unnecessary or extraordinary.

- Supreme Court seems to disavow that approach:
  - Standard: Deduction would cause severe and immediate frustration of sharply defined national or state policies.
  - Public policy disallowance should be very narrowly applied.

- Statutory:
  - 162(c), (e), (f) and (g) – Congress intended statutory disallowance rules to be “all inclusive” = no judicially-created exceptions to deductibility.
    - (c) = illegal bribes, kickback and other payments - burden of proof on IRS, and if payment to private party (not government official) is illegal under state law, disallowed only if state law is generally enforced.
    - (e) = Lobbying and campaign expenses – but note local government exception. Prohibition on deduction of campaign expenses and grass roots lobbying is recent addition.
    - (f) = Fines and penalties – codifies Tank Truck Rentals rule. Should not let IRS take sting out of the fine or penalty.
    - (g) = Antitrust treble damages – two-thirds nondeductible, because it’s a penalty paid to private party. But criminal conviction or nolo plea required for disallowance b/c then the damages are a penalty or a fine.

- Only apply to § 162(a) = business expense deduction.
  - Misseye(?) tried to take 165 loss deduction not 162 business expense deduction so the limits above did not apply to him.

- 280E = Drug dealing expenses nondeductible – does not disallow cost basis in drugs.

Depreciation = 167 Deductible if:
- It is used in a trade or business or for the production of income AND
- It wears out through use of passage of time
- § 167(c)(1) = Tax free return of adjusted basis is allowed during the period in which the asset is used to produce income
VI. **Expenses Not Productive of Income**

- **Distinguishing Consumption** = competition between 262 and 263 (disallowance) and 162 (allowance)
  - Net Income = Gross Income – Expenses of Producing Income = Consumption + Change in Wealth: \( Y = GI - Exp = C + \text{Change in } W \).
    - \( Exp = §§ 162, 167 \) (depreciation deduction), 212 (investment related expense deduction), current expenses and depreciation.
    - \( C: § 262 \) (personal, living or family expenses nondeductible – ever!)
    - Change in \( W \) = net saving or dissaving – Savings - § 263 (capital expenditures nondeductible); Dissaving - § 165 (losses deductible – disenrichment)

- **Capital Expenditures** = 263 disallows deduction, but you should get your ROC.
  - § 1012 cost or § 1016(a)(1) adjusted basis – capital expenditures raise basis \( \rightarrow \) ROC later.
  - **ROC later**, either via:
    - **Depreciation** (if property wears out in production of income), §§ 167(a) – authorization of deduction, 168 – mechanics of deduction.
      - Depreciation deductions reduce adjusted basis.
    - **Adjusted Basis offset on disposition**, § 1001(a); OR
    - **Loss deduction on disposition**, § 165(c)
    - Or maybe all 3 in combination! – see § 1016(a)(2)
  - Long-lived consumption property – house or car.
    - No ROC for decline in value b/c does not wear out producing income – see limits on §§ 167(a), 165(c) b/c the use was consumption not producing income.
    - But still get basis offset on sale, § 1001(a), so proceeds tax free to extent of initial cost – but no loss deductible.
  - **Mt. Morris Drive-In Theatre** \( \rightarrow \) Addresses the repair (§ 162) v. improvement (§ 263) distinction [= now v. later]. Tax Court majority holds cost of drainage system a capital expenditure b/c either:
    - It was an integral part of the original costs of building the drive-in; or
    - The drainage system itself was a separate long-lived asset. CB 627
    - Dissent: drainage system = ordinary repair, currently deductible under § 162(a) b/c the drainage system did
    - 6th Circuit \( \rightarrow \) capital improvements are judged by whether the expenditure increases the income producing potential of this taxpayer. Even though the drainage system did not extend the physical useful life of the movie screen, fixtures, building, etc, that’s not the point. It did substantially **prolong the economic**
useful life of the drive-in, b/c absent this expenditure the neighbors would have shut it down.

- **Focus on economic useful life not physical useful life.**
  - Dissent: Is it true that cash payment to settle neighbor’s claims for damages would have been deductible?
    - No – b/c damages paid for future flooding is in substance buying a flowage easement and would not have been deductible.

  - Idaho Power → TP claimed depreciation deductions on cars and trucks used in business, but some of the use was in building transmission and distribution lines and facilities. **Self-Constructed Property**
    - Issue: Is deduction allowed by § 167(a) as depreciation, or disallowed by § 263(a) as capital expenditure?
    - IRS – cars are wearing out producing income into the future b/c they are used to build long-term facilities – cars = cost of building the long-term facilities and consequently a capital expense and should be included as part of the basis of the facilities.
    - Decline in value of vehicles due to business use is cost of producing income, but if they wear out in constructing long-lived asset, not a cost of producing income this year. → **Timing Rule.**
      - Proper measure of annual enrichment requires capitalization…
      - Note the Supreme Court’s reliance on the priority rules of sections 161 and 261. CB 632-33
        - Disallowance rule trumps.
      - Court’s reliance on tax policy concerns, namely horizontal equity and economic neutrality – taxpayers who self-construct should be treated the same as those who contract-out the work. CB 631-32
    - All acquisition costs become part of basis.

  - **Business v. Personal Expenses = if no way to unscramble, all or nothing primary purpose test:** Was the expenditure in question primarily related to business or personal in nature?
    - Henry C. Smith → Cost of childcare services for TP’s preschool children not deductible in 1937 as T or B expense despite fact that required to permit wife to work outside the home.
      - 162(a) – ordinary and necessary expense paid to permit her to carry on her business as employee.
        - Not a cost to “carry on” her employment – not an expense that advances her employer’s interest → No need to turn to 262.
        - More a preparatory expense than an expense directly related to carrying on business.
      - 262(a) – childcare is personal expense and nondeductible
• Childcare is not like food, shelter and clothing b/c all TP’s must incure such expenses w/o regard to their business or employment – Basis of TP’s argument here is not that but for the childcare she could not work; essential point is that but for the work she would not have to pay the childcare costs.

• Purpose of § 162 to reduce GI by costs of producing it, so that we tax only net income = actual amounts available for consumption or saving. Question whether childcare is cost of producing working mother’s income ultimately depends upon motivations.
  o Did working woman decide to have children, even though career most important to her? If childbearing decision is voluntary, and expenses foreseeable then childcare expenses just an aspect of personal decision to have children.
    ▪ Childcare expense = part of personal decision to have children.
  o Woman first decided to take job after children were an established fact – childcare expenses look more like cost of producing income.
    ▪ Childcare expense = cost required to earn income.

• Can’t objectively measure psychological motivations that influence decisions to work and bear children, so must simply choose objective, bright-line rule that applies to all – which alternative is more common?
  ▪ Clothing  ➔ Pevsner says clothing costs are **nondeductible if the garments are useable outside the workplace (distinguish from uniforms)**
  ▪ Business Meals  ➔ Moss holds lunches **nondeductible** b/c meeting necessitated by business, but eating was not
    ▪ **Deductible maybe if:**
      o **Build camaraderie with clients and customers**
      o **Constrained consumption** = taxpayer forced to eat at a disagreeable or too expensive restaurant
        ▪ Deduct only the amount by which the meal expense exceeds consumption value
  ▪ **Business Entertainment**
    • § 274(a)(1)(A) = Objective Disallowance  ➔ costs of activities generally considered to constitute entertainment, amusement or recreation are disallowed.
      o **2 exceptions:**
        ▪ Item “directly related to… the active conduct of the taxpayer’s trade or business” = deductible (i.e. dinner and a ballgame with a customer = ok)
• Schmoozing if the entertainment occurs “directly preceding or following a substantial and bona fide business discussion” and is “associated with” active business. (i.e. work with a client during the day and take them to dinner and symphony at night = deductible even for spouses)
  • § 274(a)(1)(B) = no deduction for yacht or hunting or fishing lodge to cultivate customers

• **Other situations**
  • § 274(e) = Foreign travel = single item expense allocated part business and part consumption based on days devoted to business and pleasure
  • § 280A = Business use of personal residence = no deduction allowed tenant for portion of rent paid, nor to homeowner for portion of depreciation, maintenance and insurance expenses; 4 narrow exceptions apply
  • § 280F = Business use of “listed property” = recapture of prior accelerated depreciation deductions if and when business use falls below 50%.
  • § 262(b) = Residential telephone line = nondeductible even if phone used most of the time for business

  o **Travel Expenses**
    • 1.162-2(e) = commuter expenses are not deductible. These expenses also do not occur “while away from home.” Not incurred “in carrying on any trade or business” – location of residence is a personal choice (or is it?). Not while carrying on, but in carrying on.
    • 274(c) disallows a deduction for expenses “not allocable to such trade or business or to such activity.” However, 274(c)(2)(B) says the exception does not apply if the personal time is less than 25% of the total time on such travel. The total time of the travel is 8 days, 3 of which were spent sight seeing – constituting more than 25% of the trip, so any money spent sight seeing is NOT deductible.

  o **Legal Expenses**
    • US v. Gilmore → other side of the Raytheon rule (payor expenses deductible?); no deduction for litigation of divorce even though the litigation was used to retain ownership of his business.
      • **Depends on origin of claim (causation of injuries); because of what were the damages paid?**
        • Personal = no deduction
        • Business = deduction
      • § 212 = amount paid for “conservation… of property held for the production of income” = deductible
Interest and Taxes
- Interest from bonds = taxable income
  - The rest of the code is used to define Taxable Income starting with § 63
  - Taxable income = gross income – deductions
  - § 61(a) Gross Income = interest but not interest on state or local bonds
    - § 103 excludes municipal and state bond income from gross income.
- § 164(a) – 1st example of deduction → some taxes paid can be deducted from gross income, including (3) State income taxes
  - Recognition that sometimes money goes out involuntarily and b/c that money is not available for consumption you should not be taxed for it
  - Local taxes pay for roads, baseball stadiums, police, schools, sewer and local government
    - It’s not robbery b/c we get something out of the taxes
    - These taxes vary from state to state and municipality to municipality
    - Fairness between the states requires deduction
- § 275(a) – Certain taxes are NOT deductible including (1) Federal income taxes
  - Federal taxes primarily goes to Defense Spending
    - Closer to robbery b/c we get very little out of it immediately
  - These taxes do not vary by geographical location – no deduction necessary
  - In order to get the same monetary value of a 50% without a deduction, the Feds would have to tax people at 100% if they allowed the deduction

Charitable Contributions

VII. Capital Gains & Losses
- Preferential Treatment of Gains
  - Realization and Capital Gains
    - § 1(h) = Maximum Capital Gain rate; 1(h)(1)(C) = 15% maximum rate of tax on net capital gain
      - 1222(11) = Definition of Net Capital Gains = Net long term capital gain – net short term capital loss
        - Held for more than 1 year = long term
        - Held for 1 year or less = short term
      - 1221(a) = Definition of Capital Asset = Property held by the taxpayer (whether or not connected with his trade or business)
        - 1221(a)(1) – not including “inventory” → property that’s held primarily for sale to customers during ordinary course of business
    - Policy:
      - Inflationary gains should not be taxed the same
- 1001 Gain = amount realized (in current dollars) – adjusted basis (in historical dollars)
- Could better be fixed by inflating the historical costs turning the formula into: gain = amount realized (in current dollars) – adjusted basis (in current dollars)
  - Bunching of income → annual progressive tax; taxing small amounts of the gain year-by-year is much different from taxing all of the gain at the end when you take the increase in the property out by selling it.
  - Income averaging is the better way to fix this → treat the gain as if it was earned over a period of years and not all at once
  - Capital lock-in = taxpayers will be deterred from responding to the market b/c of fear of taxation
    - Compromise between full taxation and non-recognition.
    - Doesn’t living in a world in which liquid funds are the way to acquire things discourage capital lock-ins? You can’t buy things with $1 mil. worth of Microsoft Stock – you have to liquidate that to buy things.
    - Bribe for the wealthy to switch their investments and diversify the economy.
- Wealthiest get tax deferral under realization and then pay only 15% on gains received from the disposition of their property
- Limit on deductibility of capital losses
  - 165(f) Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in §§ 1211 and 1212
    - 1211 = capital losses are allowed only against capital gains above $3000 which can be deducted against ordinary income
    - 1212 = carrybacks and carryovers – can’t deduct all of your capital losses until you have capital gains to deduct from
  - Taxpayer has unilateral control over timing of capital losses and gains – incentive to contemporaneously recognize capital gains and losses
    - About $60 billion lost every year because of reduced capital gains rate.

Limitation of Losses