Federal Income Tax Outline

Overview and Policy behind the Federal Income Tax

I. Rules, Strategies, Policies
   a. Statutory Interpretation Rules
      i. Absent a statutory definition, legislature probably intended words to be understood according to common usage (plain meaning rule)
         1. Can argue that Congress never thought of situation at hand and it is not a deliberate reference to common usage
         2. If not common usage then must deal with ambiguity
            a. Reason by analogy
            b. Look to legislative history
            c. Infer point of provision from overall structure and function of statute
      ii. If policy of a statute is clear then its language should be interpreted to carry out that policy even if interpretation inconsistent w/ common usage
         1. Applies when clear purpose and words create unintended result
         2. Policy so weighty, assume Congress did not mean what they said
      iii. Always check for statutory cross references
      iv. Make sure to read whole § for the meaning of words in context
         1. Read to the end of § which may be pages later
         2. Read introductory clauses which may be before subsection at hand
         3. Indentation and punctuation can be critical to interpretation
      v. Lists of examples used in the statute
         1. If the statute has a list that includes certain items, includes signifies that the list is not exhaustive and should not be deemed to exclude other things within the meaning of the term defined
         2. If the statute says that a word means a list of examples then it is a closed set, comprehensive definition
      vi. Negative Implication – implication exists because a § would have no reason to exist without implication, difficult to argue
      vii. Drafting technique: concise statement of the rule, followed by definition of terms, which may need further definitions, iterated ad infinitum
   b. The Role of Treasury Regulations
      i. Three types of regulations
         1. Interpretive – Readings of the tax code that are advisory; Most of the regulations; Court is skeptical and can be challenged as an interpretation as one of the parties involved
         2. Legislative – Treasury filling in the details when the code leaves holes; binding on the Court as delegation of legislative power
         3. Procedural – Methods proscribed to challenge or enforce the code; Defernce given by the courts
      ii. Numbering of Treasury Regulations; for example §1.132-6(e)(1)
         1. Number to left of decimal is general subject matter to which regulation pertains: 1=income tax, 20=estate tax; 25=gift tax
         2. Number to the right of decimal, before dash refers to section of the code to which regulation relates: section 132

3. Number to right of dash is regulation number: dash 6 regulation
4. After the dash number, regulation subdivisions are indicated

c. Tax Reduction Strategies
   i. In order to lower tax burden, spread the money among lower income family members, so more is taxed in lower brackets
      1. IRC 1(g) – "Kiddie tax" – counters this tax strategy by imposing the greater of the child's or parent's tax percentage on the child's income if the child is under 14 and either parent is alive
         a. The Kiddie tax results in a tax between the child and parent's tax levels by taking either the child's tax if it is earned (wages, salaries and professional fees) or the child's tax on net unearned (there will be some due to standard deduction) and the parent's allocable tax on the rest
      2. This approach is also constrained by the type of ownership that common law requires for tax liability – see above
   ii. Shift income to years when the individual with tax liability will have lower income because income tax is based on yearly income
      1. Defer tax to later year. 2 advantages
         a. Can earn the income of money pre-tax
         b. Can choose to pay tax in year of low income

d. Tax Policy: Fairness and distributive justice – main question of tax system is how to fairly distribute requirement to support government
   i. Vertical Equity: Individuals in substantially similar situations should be treated the same and vice versa
   ii. Economic Neutrality: In a free market, the law should interfere with economic decision making as little as possible
      1. Should not create incentives to change what people consume, how much they save, how they invest or how much they work
         a. People are happiest if they control their own decisions
         b. Income tax inherently deter work because leisure is tax free
      2. Commonly unequal treatment of similar taxpayers results in a distortion of value in free market. This reduces the overall welfare because individual spending decisions are influenced and we assume that people making there own decisions maximizes welfare
   iii. Income tax base vs. consumption tax base
      1. Today we have compromise between consumption and income tax
         a. As we allow deductions for savings such as retirement we move from true income tax toward consumption tax
      2. Because we are trying to reach net increase in resources to spend and resources are either used in spending or savings, net income can be represented by GI – expenses or Consumption + Δ wealth
      3. $Y = GI - Exp = C + \Delta W$
   iv. TP can't obtain double tax benefits on the same transaction
      1. *Haverly v. US* – schoolteacher doesn't report books as income then takes deduction for contribution of the books
   v. Non-enforcement policies: IRS won't enforce when

            1. Enforcement would cost more than net revenues of benefit
            2. Would piss TPs off and inhibit the willingness to comply with law

II. Intro: Who should be forced to support the govt and to what degree
    a. Who?: "There is hereby imposed on the taxable income of every individual" a tax
        i. "Individual" is undefined even in §7701 (list of defined terms)
            1. Define individual by commonly understood meaning and exclusion: human being, not head of household or surviving spouse
            2. Congress meant to tax every individual: §6012: if unable to file, then must be filed by agent or guardian; §2 Tax on Res. Aliens
        ii. "Taxable Income" – GI - the deductions allowed by this chapter: §63(a)
            1. §61 – "Except as otherwise provided, gross income means all income from whatever source derived"
                a. Including, but not limited to list (interest is on list)
            2. May be another point in code where income is excluded
        iii. Owner of the income is the individual responsible – "TI <u>of</u> individual"
            1. This dictates who is liable for the tax which is important b/c percentage taxed is according to the income of individual
            2. Ownership depends on "beneficial enjoyment and practical control" rather than state property law concepts and legal title
                a. Beneficial enjoyment and practical control doesn't always point in same direction (mom w/ control for child's benefit)
                b. Assignment of income doctrine – judicially developed guidelines for income tax ownership
                c. IRC 671-78 codified doctrine for trusts, for legal interest in property judicial guidelines still apply
        iv. Congress answers who? by imposing a universal tax – every person taxed
    b. In what proportion should people be taxed: Progressive Rate system
        i. Types of tax rate schedules
            1. Progressive tax (our system): rate increases as income increases
            2. Regressive tax – rate decreases as income increases
            3. Proportional tax – flat tax rate, tax increases at same rate as income
        ii. Vertical Equity: Total income is sub. different cir.; different tax OK
            1. Those who can, pay more - only speaks to the lowest income sector who should not be pushed into homelessness and hunger
            2. Beyond the lowest income group fairness concerns and declining marginal utility of money explain this system
                a. Declining marginal utility of $: dollars less valuable to wealthy, should minimize total sacrifice of our society
        iii. Progressive rate uncontroversial since beginning of income tax, but there is a recent attack politically on this structure
            1. Higher tax bracket will never decrease amount of take home pay
            2. Refusal to take on more work due to tax consequences only rational if the lower percentage of pay earned is not worth the leisure time given up: economic neutrality
        iv. Economic Neutrality: Progressive rates compound the inherent deterrence of work in income tax b/c the larger the income the larger the deterrence

            1. Only if we tax leisure time or have a head tax can we reach economic neutrality through income tax
            2. We value fairness more than economic neutrality so head tax is out
      v. Rate schedule currently found in §1(i)(2)
   c. How do we tax organizations: §11 Corporate Income tax
      i. Corp (§7701) includes associations, joint stock cos, and insurance cos
         1. §7701 defines "where not otherwise distinctly expressed or incompatible with the intent thereof"
         2. List uses the word "includes" which is not exhaustive
         3. Association originally referred to unincorporated businesses
      ii. City not listed as corporation, but exclusion of income from public utility and govt. functions (§115) suggests that city is corp., negative implication
         1. If a city is not a corp. §115 has no meaning
         2. §115 exempts income derived from public utilities and essential govt. functions (both undefined = common usage)
            a. If city does anything normal it will not be taxed, a city run bank will probably be taxed
            b. Essential governmental function exemption = inter-governmental tax immunity, federalism concerns
   d. International Reach of the Federal Income Tax
      i. Three independent grounds for US tax liability
         1. Citizenship – citizens subject to tax liability on worldwide income even if not resident and no money comes from US - §1
            a. Justified by benefits of being citizen like diplomatic protection, but these benefits pale in comparison to others
            b. One of 2 nations who tax based solely on citizenship
         2. Residency – residents subject to tax liability on worldwide income even if not a citizen and no money comes from US sources - §1
            a. Justified due to benefits of political and social system
         3. Source – Non-resident aliens have separate rules for tax liability
            a. Justified b/c income received by exploiting US economy
      ii. Allowances made for taxes paid to other countries
         1. Eliminates negative income which destroys international trade
         2. Treaties set up tax priority: country of source gets first cut, then country of residency, then possibly citizenship
         3. W/o Treaty US unilaterally grants deduction and credit
      iii. Non-resident alien taxability – Congress meant to tax "every individual" as confirmed by §2 (referring to §§ 871 and 877)
         1. §871(a) imposes gross withholding tax of 30% (on gross amount received- no deductions or withholdings) by non resident alien if conditions met – collected from US corporation before paid
            a. From sources within US
               i. Dividend from US corp is from source in US (§864)
                  1. If corporation is organized in the US or does more than 25% of business with US (§861) then it is a US corporation

                2. Tax stops corps from moving offshore
            b. One of specified types of periodic income
            c. NOT effectively connected with trade or business w/in US
                i. Trading stock is not effectively connected
        2. §871(b) imposes §1 rate schedules on TI that is effectively connected with trade or business w/in US
        3. If not effectively connected and does not meet §871(a) then no tax
    iv. Expatriation to Avoid Tax: §877
        1. If individual moves abroad and renounces citizenship, they are still taxable according to §1 rates for 10 years
            a. Applies if net income for previous 5 years is greater than $125 or net worth is more than $2M
            b. Even if not met, TP must prove compliance to void this tax

III. Tax Computation
- a. Definitions and Calculations
    - i. Gross Income = Gross Receipts less loans proceeds, cost of goods, and exclusions
        1. Loan Proceeds – b/c they come with equal liability, no enrichment
        2. Cost of Goods Sold – GI only includes gains from sale §61(a)(3)
            a. Gains = Amount realized – adjusted basis (§1001), where adjusted basis = cost of goods sold (roughly, §1011,1012)
        3. Exclusions (§101-39)
    - ii. Adjusted Gross Income (§62) = GI minus nonitemized deductions
        1. Nonitemized deductions are listed in §62(a)
        2. Essentially nonitemized deductions are business expenses (also loss from sale of property and alimony payments)
    - iii. Taxable Income (§63) = Adjusted Gross Income minus itemized deductions or the standard deduction (§63), and personal exemptions (§151, compare §262)
        1. Itemized deductions include most investment and personal deductions, only used if greater than the standard deduction
    - iv. Tax Imposed = Taxable Income times scheduled rates (§1 or §3)
    - v. Tax Due = Tax Imposed minus credits (§21-52)
- b. Value of a Deduction
    - i. Reduce base of tax liability, grants savings based on the tax rate applied
        1. Increase value in a deduction to people with higher income
        2. Itemized deductions only valuable if greater than standard deduct.
    - ii. Two types of deductions
        1. Cost of producing income deductions – desire to reach enrichment means that should not tax cost of producing income
            a. Economic neutrality and fairness concerns
            b. Roughly speaking nonitemized deductions
        2. Personal deductions – Congressional encouragement or subsidy though tax system for certain types of behavior or activity (mortgage interest, property or state taxes, charitable contributions)
            a. Roughly speaking itemized deductions

b. Itemized deductions only valuable if greater than standard deduction – 40% of pop. itemize, usually homeowners

iii. Personal Exemptions - recognizes need for minimal core consumption

1. Minimal amounts for essentials like food, shelter, and clothing – avoid homelessness and starvation
2. §262 – no deductions allowed for personal living or family expenses, but §151 is an exception to this rule

c. Exclusions – like a nonitemized deduction, saves tax according to applicable rate

i. Typically reference value received while deductions reference value spent

ii. Traditionally exclusions were not reported to IRS and deductions were

d. Credits – like personal deductions in creating incentive for other reasons, but incentive is independent of TP's tax bracket b/c refunded after tax imposed

i. Credit granted for certain percentage of donation – 25%

e. Credit vs. deduction

i. Treasury indifferent because bottom line is equal

ii. TP will prefer deduction if tax bracket is greater than credit percentage

iii. Donees will prefer whichever group is more likely to give to them

IV. Business income tax fundamentals

a. Classical corporate income Tax – corporation taxed on profits like and individual

i. Double tax on distributed profits b/c corporation taxed as entity on profits earned, §11, and individual taxed on distribution of dividends, §61(a)(7)

ii. No deduction allowed to corporation for distributed dividends

1. Problematic b/c other corporate distributions are deductible; interest on loans, rent on leased property; salary to employees
2. Encourages double relationships w/ shareholder to evade double tax - Shareholders give loans or are corporate employees

b. Pass Through Business Taxation (partnerships and LLCs) – no tax on firm as entity, instead tax business profits to owners when earned whether or not distributed; no tax on distributions. IRC §§701, 702(a), 731(a); TR §1.702-1(a)

i. Single tax b/c no tax on distribution – tax on earning

ii. Limited partnerships do not allow withdrawal of $ on demand which makes Pitney's argument for substantive differences problematic

c. Massive non-neutrality in the form of business taxation

i. Likely w/in my career US will adopt a form of integrated tax regime (like all of Western Europe) to deal with non-neutrality

Scope of Gross Income

I. *Old Colony* –Company agrees to pay taxes, payment is an increase in income

i. IRS needs code authority to tax because Constitution gives Congress the ability to lay and impose taxes

ii. TP argues that the payment of taxes is gift, but this is rejected b/c business context does not have motivations that normally underlie gifts

iii. TP argues that not income because this would result in absurd result of taxing again and again ad infinitum, Court rejects as uncertified question

1. Rejected on principle b/c there is a finite limit to the taxation
2. Tax on what is already paid as tax is done with everyone in withholdings under §3402 without deduction, §275

b. Substance over form - Common usage of income would not include b/c $ not received, but discharge of liability by 3d person equivalent to income
c. Horizontal Equity -Economically equivalent transactions must be treated the same
    i. Fairness – people who work for companies who do not set up tax paying regime (not worth it to small company) would have greater tax burden
    ii. Ignore formal distinctions, substantially similar based on net enrichment
d. Economic Neutrality – the unstated premise behind the decision
    i. Formal distinction between money received and paid (2 steps) and liability discharged (1 step) creates an incentive to reorganize interactions
    ii. Even w/ good reason to interpret toward form (plain meaning rule) must recognize substance over form
e. When 3d party pays legally enforceable obligation to any party, receiver enriched

II. Forced Savings and Forced Consumption
a. *Bengalia* (Tax Court 1937) – Manager of Royal Hawaiian receives free meals and lodging for he and wife, majority finds that he does not have to include as income b/c meals and lodging are "incident to duty" and for "convenience of employer"
    i. Enriches b/c relieves expense – failure to tax not justified on enrichment
        1. Dissent argues that meals and lodging intended as compensation, not convenience of employer b/c not necessary, and tax should be based on income not the purpose of the hotel
        2. Usually whether employer can deduct parallels whether employee must report, but there is no rule making this the case
    ii. Convenience to the employer
        1. Business necessity – "b/c could not perform services required"
        2. If business necessity then it is constrained consumption
    iii. Bengalia example and forced consumption understanding will be used to argue whether a new forced consumption statute makes sense.
b. Proper valuation of constrained consumption
    i. Fair market value: unfairly taxes b/c TP may have spent less money on a service if left to own decisions on spending
        1. Differentiate optional spending (Bengalia hotel living) and legal obligation (Old Colony tax liability)
        2. Cannot assume benefit equals retail price
    ii. Subjective Value:
        1. Theoretically the only way to meet economic neutrality and void distortions of market choice
        2. Difficult to administer b/c cannot objectively and independently measure which leads to inconsistent unfair application
        3. In rare situation where there is objective evidence, we can't impose this standard b/c we normally don't have information and it is unfair to punish people in cases where we do
            a. Also we don't tax consumer surplus (excess value gained when consumer value is higher than price)
    iii. Replacement costs (expenses avoided) are rational choice for income because they objectively measure the enrichment of the recipient

            1. Approach adopted by court in *Reginald Turner* (won NON-TRANSFERABLE tickets to South America) because court finds that benefits were obtained from expenses avoided
      iv. Employer Cost:
            1. Incorrectly focuses on the cost to the employer rather than the enrichment to employee
            2. Administrability problems when employer may have variable costs based on whether room would have been rented, etc.
            3. May be suitable proxy for enrichment when cost of alternative arrangements and subjective valuation are less easily ascertainable
      v. Zero: Employee benefit is greater than zero b/c employee enriched
            1. Horizontal Equity: Unfairly gives preferred treatment to individual who has benefits b/c same enrichment w/ less tax liability
            2. Economic Neutrality: failure to tax for value of expenses avoided will influence persons to choose salary plus benefits rather than more salary and market will shift to favor lower salaried jobs which eventually benefits the employer, which results in lower hotel prices and a misallocation of consumer resources
                  a. Govt subsidy for use of hotel through distorted market

III. Valuation of In-Kind Income (current law) – Congress provided that there are only exceptions if included in the Code – no judge made exceptions
   a. General Rules
      i. IRS does not concern itself with unsolicited samples unless failure to tax the samples would provide the TP with double benefits
            1. *Haverly* – schoolteacher taxed on books b/c she claimed deduction
            2. Even though enriched IRS doesn't enforce because enforcement would be more expensive than net revenue
            3. IRS wants to maintain compliance (perceived fairness important)
      ii. When transferable goods and services are obtained, tax at Net FMV
            1. Must include some deduction for cost of selling
            2. Correct theoretical FMV based on value that individual could obtain in *their* market, possibly different than retail (ebay today)
      iii. Non-transferable goods and services
            1. General rule: perhaps expenses avoided (Bengalia dissent, Turner)
            2. Employer provided benefits
                  a. Meals and Lodging: §119
                  b. Health Insurance, Pensions, and other goods/services under individual IRC exclusions
   b. §119: Meals and Lodging exception
      i. The Cases that develop the law
            1. *Kowalski* – state trooper meal allowance and Court concludes that payments are taxable as "undeniable accessions to wealth, clearly realized, over which respondent has complete domininon."
                  a. Court reads code and regulations as in cash v. in kind distinction and interpretation makes one prong of treasury regulation mere surplusage

2. *Sibla* – firefighters who buy groceries together allowed to take deduction, but Kennedy argues that they had personal choice about food and how much to spend so exclusion should not apply

ii. The Rule regarding meals

1. Treasury Reg 1.119-1 requires 1) convenient to employer, 2) at place of employment, 3) Business Necessity (Bengalia)
2. Congress enacts §119(b)(3) to remove in cash v. in kind distinction created in Kowalski

iii. Principle: Forced consumption should in some cases be treated as a transaction not dependent on significant elements of personal choice

iv. §107 grants untaxed home for ministers of the gospel

1. No convenience to the employer limitation and no requirement of constrained spending
2. Rental allowance also excluded from GI to the extent that money
    a. Is used to provide a home (different from house)
    b. Does not exceed fair market value for taxable year (no excess allowance to pay down mortgage)
3. IRS challenges scam of creating own church by denying individual characterization of "minister of the gospel"
    a. Must be able to objectively show ministerial duties
    b. If ministerial duties, IRS will not challenge church

v. §119(d) provides alternative to business necessity arguments for free housing to educational institution employees

1. Broad exclusion for qualified campus housing to employee
2. Exclusion does not include 5% of fair market value (or average rent paid) minus the rent paid.
    a. If individual pays no rent, 5%FMV added to GI

c. §132 Fringe Benefits Exclusions – gives 8 possible exceptions to GI additions for certain fringe benefits, if fringe benefit does not meet one of exceptions then it is included as GI at FMV (Fringe benefits included as GI under §61)

i. No-additional Cost Service Fringe – conditioned on special rule below

1. Service must be offered to customers in ordinary course of bus.
2. Employer must incur no substantial additional cost (w/o regard to any amount paid by the employee)

ii. Qualified Employee Discount Fringe – conditioned on special rule below

1. Property: Discount not GI "to the extent that" it does not exceed the gross profit percentage of employer
    a. Gross profit percentage measured on all goods or a reasonable classification of property selected by employer
2. Service: Discount not GI up to 20% of price to customers

iii. Working Condition Fringe

1. Exclusion for property or services that would be deduction under §162 (business expense deduction) or §167 (depreciation)
2. Commuting is not deductible as business expense
3. Product testing qualifies as working condition fringe if

a. Consumer testing and evaluation must be an ordinary and necessary business expense of the employer
b. Business reasons must necessitate that testing and evaluation be performed off-premises by employees
c. Item must be furnished for purpose of testing
d. Item made available no longer than necessary to test and it must be returned at completion of testing period
e. Employer must impose limitations on employees use that significantly reduce value of personal benefits
    i. Must meet three requirements: limit employee ability to select models, members of family generally can't use item, same type of item leased
f. Employee must submit detailed reports on testing

iv. De Minimis Fringe – property of such value so small as to make accounting unreasonable or administratively impracticable
    1. While code focuses on aggregate, Treasury regulations and applications focus on individual
    2. Firm meal money is shown to be reasonable accounting so it must be included as GI

v. Qualified Transportation Fringe – includes transit passes, qualified parking, or commuter highway vehicle
    1. Commuter highway vehicle must be used 80% toward getting employee to work, have seating for at least 6, and use at least ½ seating capacity toward getting workers in, not including driver
    2. Exception for company provided vanpools

vi. Qualified Moving Expense Reimbursement

vii. Qualified Retirement Planning Services

d. Special Nondiscrimination Rule
    i. For no-additional cost service, qualified employee discount, and cafeteria
        1. Apply to highly compensated individual only if substantially the same terms are offered for each member of a group of employees defined under a reasonable classification (no discriminating)
        2. Reality of situation determines if benefit - discriminatory function
    ii. Both coverage (reasonably classified group) and amount (substantially the same terms) must be nondiscriminatory
    iii. Reasons and justifications for the rule
        1. Congress did not want to take away all employee discounts b/c of potential negative public response
        2. Compensation policy governed by board of directors at suggestion of president so there is reason for suspicion of program limited to the high paid end of work force
        3. Anti-abuse rule justified
            a. Low end employee would lose respect for tax system if highly paid got benefit from company and tax system
            b. Tax based incentive for more egalitarian distribution of benefits or incentive to not offer benefit at all

            i. Covert redistribution scheme
      iv. Origin of rule in 401K and other retirement plans

IV. Imputed Income
   a. Imputed income from goods: Using home that you own to eliminate rent costs
      i. If house rented out then taxed on the income derived
      ii. When house lived in on own, not taxed for gain in expenses avoided
      iii. One of tax incentives toward owning own home – Congress believes that we are better off if there is an incentive to own home
   b. Imputed income from services: Stay at home mom is doing services which otherwise would gain pay and avoiding cost of finding services on market
      i. If mom performed services for other she would get income and be taxed and pay for the services to be provided by another
      ii. Because mom does work on her own the imputed income is not taxed
         1. In order to make sense financially, salary outside home would have to have after tax gain greater than replacement services
      iii. Enormous incentive to provide services in home rather than on market
   c. Economic Neutrality: Ways to equalize tax treatment and eliminate incentives
      i. Tax both: tax imputed income just as regular income so that both taxpayers pay same amount of taxes on their savings or efforts
         1. Administratively difficult to determine value of imputed income
         2. Difficult to draw line as to what creates taxable imputed income
      ii. Tax neither: Do not tax interest income or allow deduction for rent or other valuable items creating imputed income from goods
         1. Easier administratively, but lost revenue made up in other taxes
   d. Economists argue that imputed income for services is an enormous strain on economic production because value is lost from women not being in market
      i. Originally deduction provided for dependent domestic services, but this has been replaced with a credit, §21
      ii. Replacing deduction with credit is Congress targeting relief at low income
   e. Drawing the line for imputed income
      i. GI received when services are received from someone outside of home
      ii. Untaxed imputed income when services are self performed or performed by another member of the same household
      iii. Our income tax is marketplace income tax
   f. Carpools are a marketplace transaction and should be GI, but since 1950's Congress has decided (prosecutorial discretion) not to go after carpool income b/c it would end up being a tax on honesty and engender a disrespect for tax system

Tax Treatment of Damages

I. The Raytheon Replacement Rule: In lieu of what were damages awarded
   a. When damages are recovered tax treatment is decided by substance of transaction
      i. Damages for lost profits are taxed
      ii. Damages for destruction of property are gross income only to the extent that they exceed the cost of property (nonrecognized)
         1. GI = sale proceeds - cost basis (maybe capital gain)
   b. Raytheon replacement rule is critically dependent on facts of transaction
      i. To determine what is replaced look at best available objective evidence

ii. If business completely destroyed treated like voluntary sale
iii. If not completely destroyed treated like lost profits
    1. Alternative to lost profits is loss in goodwill or partial destruction of business which is not taxable, but goodwill almost impossible to separate from lost profits unless it purchased from previous owner
iii. If tangible property is destroyed then repair of property is capital return
    1. When difficult to draw line between profits and underlying capital the court will treat all loses as lost profits
iv. When tangible property is damaged but not destroyed and value of property has increased the damages can represent either the return of invested capital or the return of appreciated value; ROC methods
    1. ROC first - tax only what exceeds capital on damage payment and on later sale tax everything b/c capital already returned tax-free
    2. ROC Pro-rata – untaxed pro-rata share of damage payment and later leave remaining amount of capital investment untaxed
    3. ROC Last – Tax all of damage payment leaving untaxed return of capital for later realization
    4. §1033 – Nonrecognition: tax zero of the damage payment if money is invested in repair or replacement – later tax all but the original capital return

c. Theoretically Proper Tax Treatment of Damages under Raytheon
    i. For employment K broken – tax all b/c damages replace income
    ii. For wrongful destruction of property – tax lost profits, don't tax repair of property if reinvested under nonrecognition
    iii. Malpractice Damages (eg. *Clark* – payment to replace money lost in poorly computed tax return) – tax free b/c damages represent loss of savings which have already been taxed
    iv. Compensation for breach of promise to marry
        1. Out of pocket expenses incurred: tax free as replacement of spent money which was already taxed on receipt
        5. Emotional damages untaxed as replacement of imputed income
    v. Damages for auto accident caused by drunk driver
        1. Medical expenses: replace savings already taxed should be tax free
        2. Pain and suffering: Replace happiness, tax free imputed income
        3. Lost Wages: Taxable as replacement of income
        4. Lost Earning Capacity: Taxable as replacement of future income
        5. Punitive Damages: Dont replace any lost rights, taxable as windfall
    vi. Punitive Damages and Payments of Public Fine to Private Party are taxable as windfalls under Glenshaw Glass

II. Congressional Simplification of Damage Replacement rules

a. Tax Status of Damages Under §104 – Raytheon established presumption of taxability which can be refuted by statutory exemptions from Congress
    i. Medical expenses: excludable – correct as above
    ii. Pain and Suffering (physical): excludable – correct as above
    iii. Emotional Distress: Arguments only occur when emotional damages are not due to physical injury to the plaintiff b/c the test is causal

            1. Expressly excluded for any amount spent on medical care for treatment of emotional damages §104(a)
            2. Beyond damages not expressly excluded,
                a. Argue: analyzed under Raytheon replacement rule
                    i. Emotional health – imputed income, not taxable
                    ii. Lost wages - taxable
                b. Argue: Final sentences of §104 show Congress wanted to tax emotional pain and suffering beyond med expenses
            3. Justification: Congressional suspicion of state court system and the validity of claims not backed by physical injury
        iv. Lost Wages: excludable if they are "any damages received on account of personal physical injuries or sickness" – taxable under Raytheon
        v. Lost Earning Capacity: excludable as compensatory damages – taxable under Raytheon
        vi. Punitive Damages: Not listed as exclusion under §104 so analyze under Raytheon replacement rule – enrichment taxable as above
    b. Justifications for §104
        i. Perceptions of fairness: Looks bad if Congress taxes injured people
        ii. Fairness to winner of lawsuit may not get entire amount (lawyer's fees)
        iii. Timing Issue: Amount received taxable in one year which would bring a higher rate (every year a small amount should be taxed at lowest rate)
        iv. State court will not separate the damages so trial must allocate damages
            1. Still a problem b/c punitive damages must be taxed
            2. Judicial economy rational undercut by new punitive damage rule, but in many systems punitives must be separated
        v. §104 - irrational overreaction to the fairness issue causing under taxation
III. Application of Tax Rules to Damages
    a. Check for specific statutory treatment of damages in §104
    b. If §104 does not specifically exempt income consider Raytheon Replacement rule and determine if damages are taxable
    c. Check Tax Benefit Rule: if damages had previous deduction must be included as income to offset (see below)
IV. Loss Carryover and Tax Benefit Rule
    a. *Sanford and Brooks* – found that dredge and fill company recovering when US lied about character of material to be dredged was liable for tax even though the damages simply got the dredge company back to even in the transaction
        i. §441 Period of computation – Taxable income shall be computed on the basis of the TPs taxable year
            1. For the year in question the dredge company enriched
            2. Losses were taken in another year
        ii. No 16th Amendment issue b/c practical admin requires annual accounting
            1. Annual accounting prevailing practice at time of enactment
            2. Ruling on constitution would make all taxes con. Issues
    b. §172 carryover of deduction as net operating loss - Losses carried over so that an individual is not taxed when overall outcome of a transaction is not enrichment

i. To avoid unfairness of Sanford and Brooks (paid 71% tax even though they only broke even on transaction) Congress enacted carryover rule that allows net operating losses from previous years to be deducted from current year
ii. Net operating loss means the excess of the deductions allowed by the chapter over gross income
iii. Can carryover net operating loss as deduction indefinitely
iv. Individuals carryover NOL only for trade or business deductions
    1. Casualty losses are treated as trade or business

c. §111 Tax Benefit Rule – tax status of recovery with intervening loss deduction
   i. Inclusionary side: If losses are deducted in tax filing and later recovered in damages, include damages as income to offset the deduction taken earlier
      1. Damages really replace after tax savings and viewed simply through Raytheon replacement rule these after tax savings should be untaxed when received as damages
      2. Deductions were taken for the losses in previous years and the recuperation of damages makes the deductions erroneous, the error must be corrected in current year, TBR corrects
      3. Simply an error correction mechanism
   ii. Exclusionary side: If intervening deduction did not do any good b/c there was no income to offset previously, the deduction was a harmless error
      1. Do not apply TBR if no value gained from original deduction
   iii. To employ the tax benefit rule there must be a "recovery"
      1. Recovery means refund of the purchase price from person paid
      2. Sanford and Brooks relieved by §172 today not §111
         a. S&B received increased pay from govt. not "recovery"
   iv. Tax Benefit Rule is employed as error correction device rather than amending original return because
      1. Earlier year may be closed by the statute of limitations, §6501
      2. §441 holds that taxable income shall be computed on basis of taxable year, and earlier year returns are correct as the facts existed in those years
   v. Intervening rate changes may mean that error correction does not do justice, but theoretically the treatment is correct under fundamental principles of tax law

d. *Dobson v. Commissioner* – tax benefit rule and Raytheon replacement rule
   i. Dobson sold shares at decreased value and claimed deduction, but then won suit for contract rescission because of failure to disclose
      1. Damages replace spent savings (already taxed) and should not be taxed, previous loss deduction for disenrichment is erroneous
   ii. For stock not sold future gain or loss determined by basis of property
      1. §1012 sets the basis of property at the cost, but
      2. §1016 adjusts basis of property for expenditures, receipts, losses, or other items properly chargeable to the capital account
         a. Dobson basis of $100 adjusted to $80 per share b/c he received $20 damages per share

V. Tax Treatment of Health Care Costs

a. Proper Tax Treatment under General Tax Regime – not applicable due to rules
    i. Health care is personal consumption cost - no deduction under §262
    ii. Fringe benefits taxable under §61 as in-kind compensation (unless 132)
    iii. Individually purchased health insurance: Saving for health care is not deductible because savings is not disenrichment
b. Current Tax Treatment of Health Care Costs
    i. Treatment of Employer Provided Coverage
        1. §106 – Premiums covered by employer excluded from GI
        2. §105(b) – Proceeds received from coverage are excluded from GI if they go toward "medical expenses" described in code
    ii. Treatment of Employee Purchased Insurance Coverage
        1. §213(d)(1)(D) – Limited deduction for premiums
            a. Only to extent that expenses are greater than 7.5% GI
            b. Itemized deduction so only to extent that deductions are greater than the standard deduction
            c. Due to limitations deduction probably won't save all that much money
        2. §104(a)(3) Proceeds of self-purchased insurance are tax free (not GI) – another codification of tax benefit rule
    iii. Treatment of employee self-insuring
        1. No premiums paid, so taxed on income
        2. Limited deductions for "proceeds" under §213(a)
    iv. Hybrid systems of co-pays and deductibles
        1. According to system employee out of pocket expenses qualify as medical expenses under §213
        2. If employee share of premium paid by wage withholding in substance it is employer provided program
        3. New §125 allows deduction for copays and deductibles
c. Choice of health care plan based on tax treatment
    i. Employer provided plans are entirely tax free, best choice for employees
    ii. Self-insurance is better than employee purchased insurance due to the limits of §213
d. Justification of tax treatment of health care costs
    i. Social policy reasons for broad based health care coverage
        1. Legislation adopted when unions had bargaining power to effectuate social policy and obtain health coverage
        2. Bribe to have employer arrange medical coverage through employer and pay some of compensation through coverage
    ii. National Health Care System Buried in Tax Code
        1. Largest tax expenditure is health care exclusion
e. Effects of Tax System on Health Care Costs
    i. Fully insured have no reason to limit costs spent on health care which results in increased demand and increased cost
    ii. Many employers have started charging employees for a portion of health care costs and cut back on insurance by imposing co-pays and deductibles

f. Recent Developments in Tax Treatment of Health Care Costs
    i. §162 – provides deduction for self-employed when sole-proprietor is working alongside employees because common law employee did not include the owner of unincorporated business
    ii. Congress classified qualified long term care as medical care
        1. Definition of qualified long term care §7702B(c)
    iii. Health Savings Accounts – contributions, withdrawals, and investment earnings in dedicated health care savings account are deductible §223
        1. Must be enrolled in high deductible health plan §223(c)(2)(A)
        2. Allows coverage for calamitous costs, creates cost consciousness
        3. Amount going in on deductible basis limited to $2,250/yr/person and $4,500/year/family to prevent use as tax free savings

g. Special rules: cosmetic surgery not included, medicines only included if prescription, disability insurance gets limited favorable tax treatment

Timing and Treatment of Income for interest earning investments – Congress hasn't made a firm commitment to specific timing rule on tax payments for interest earning investments

I. Annuity Contracts: Return of Capital and when should we tax K gain
    a. Plausible timing rules for the income portion of an annuity contract (term-certain annuity contracts); justification or analogy for each rule
        i. Return of Capital first - tax gain only after capital returned tax free
            1. Ensured that capital is returned tax free
        ii. Return of Capital Pro-rata – tax proportion of each that represents gain
            1. Based on known final tax spread evenly
        iii. Return of Capital Last – Tax contracted gain immediately
            1. Ensure receipt of tax right away
        iv. Back-loaded return of capital – Each year receive interest plus some principle which makes interest gained less each year (amortized)
            1. Treat annuity K as loan granted to insurance company
        v. Front-loaded Return of capital – Receive greater interest for money that has been held longer
            1. Like 5 individual endowment contracts (agreement to pay some of money now for right to be paid sum later) which generate more interest for longer periods of holding
    b. Tax Treatment of Life Annuities (term-specific annuities simply pro-rata ROC)
        i. Life annuities in substance two transactions in one; savings and insurance
            1. Insurance protects against living too long, outliving funds
            2. Savings just like term-certain annuity context
        ii. §72(a) default rule: GI includes any amount received under annuity except as otherwise provided
        iii. §72(b) express exclusion rule: exclude from GI in the ratio of investment in the K over the expected return; determines ROC in pro-rata calculation
            1. Investment in K = aggregate of premiums or other consideration paid minus the amount pulled from K before maturity as ROC
            2. Expected return – Total to be received under K
                a. If return is based on life expectancy then expected return is based on Secretary's actuarial tables

            b. Number of years from date annuity starts paying to life expectancy times the yearly receipt
      iv. 72(b)(3): If individual dies before receiving full ROC, all unrecovered investment allowed as a deduction to annuitant for the last taxable year
      v. For payments received after full ROC
         1. Until 1986 exclusion ratio allowed beyond expectancy– tax free enrichment for every tax free dollar after full ROC
            a. Allowed b/c beginning to tax at life expectancy causes a sudden decrease in disposable income that could be used for necessary life payments
            b. Social policy – incentive to insure against outliving savings
         2. Currently all payments after full ROC taxed in full
            a. Tax policy more important than social retirement policy
   c. Deferred Annuities- Previously §72(e) made any withdrawal of money before the beginning of the annuity K follow a ROC first approach
      i. Under ROC first, deferred annuities began paying at age 95 and $ was withdrawn ROC first before that age gaining tax deferral; tax shelter
      ii. Now general rule is that money withdrawn b/4 annuity start date is treated under a ROC last rule.

II. Income Tax Treatment of Life Insurance
   a. Theoretical treatment of life insurance
      i. Life insurance contracts are combination of term insurance and savings
         1. Term insurance: premium paid each year for 1 yr insurance with guaranteed renewal period (most affordable type)
         2. Proper tax treatment requires unbundling
      ii. Term insurance purchased by working people to provide alternate source of resources for family in event of death
         1. Replaces labor income, proceeds should be taxed
         2. As cost of producing income, premiums should be deductible
      iii. Term insurance bought by homemakers to replace lost services on death
         1. Replaces imputed income which should be tax free
         2. No deduction for payments, b/c cost of producing exempt income is nondeductible (§265(a)(1))
      iv. Insurance naming adult child'n beneficiaries bought to provide inheritance
         1. Gift and bequest excludible §102(a)
         2. No deduction for payments
      v. Treatment of term insurance bought for homemakers and adult children beneficiaries is the same, but for working people it is different
         1. Difficult to sort out proper treatment
         2. Administration counsels toward choosing one treatment
   b. Whole life insurance – Multi-year policy that pays constant death benefit if insured dies before policy maturity, at maturity insured paid amount equal to death benefit even though still living
      i. Annual premium in excess of term insurance cost deposited for savings
      ii. As balance of savings grows less needed to fund death benefit
      iii. Proper treatment of savings elements

1. Amount paid in premium above term price should properly be nondeductible, and deserve tax free ROC when repaid as proceeds
2. Growth in value of savings is interest and should be taxed based on fairness and economic neutrality

c. Actual treatment of life insurance contract (term or whole)
   i. §101(a)(1) – Proceeds received on death excludable
   ii. §264(a)(1) – Premiums generally not deductible
   iii. §72 - If policy surrendered for cash value at maturity the amount above investment in K is taxable as GI
      1. Under taxes b/c credit given for both insurance and savings portion
         a. Definition of life insurance K (cash value accumulation test) requires higher insurance portion to stop tax shelter
      2. Tax treatment favorable b/c tax on interest deferred

d. Pros and Cons of actual treatment
   i. Con: Maybe more injustice b/c wage earner purchase is more likely
   ii. Pro: Policy ignores transaction which requires less administration
   iii. Pro: Better to give tax break to those who don't deserve than tax those who should not otherwise be taxed

e. Advance Payments under life insurance K
   i. §101 exclusion does not apply b/c policy not paid for reason of death
   ii. §72(e)(5)(A): General rule for money taken out is ROC last
   iii. §72(e)(5)E: ROC last doesn't apply when $ received in full discharge of K
   iv. §101(g)(1) and (g)(4): Amounts received under life insurance K for terminally ill or chronically ill treated as if paid on death; tax free
      1. Also applies if sold or reassigned by terminally ill (override gain on sale under 61(a)(3) and 1001(a)
      2. Congress did not want to influence holding on to policy for tax free benefit when compelling need of owner is now
      3. Under §101(a)(2) transferred policy tax free benefit shall not exceed amount invested

Timing of Income: The Realization Requirement and Nonrecognition

I. Eisner v. Macomber – Mrs. Macomber owned shares of stock that declared a stock dividend. Congress defined stock dividends as income. Court finds unconstitutional

a. Range of options for disposition of corporate profits
   i. Retain and reinvest the money in the business
   ii. Retain, reinvest, and issue stock dividend to represent growth
   iii. Issue optional stock-or-cash dividend
   iv. Distribute profits as cash dividend

b. Where do we draw the line for taxable benefits in range of options with decreasing corporate control of money
   i. Revenue Act of 1916 drew the line between option i and ii.
   ii. Majority (Pitney) and dissent (Brandeis) agree that shareholder is taxable in either situation iii or iv.
   iii. Majority holds that Congress cannot constitutionally draw the line between i and ii, line must be drawn between ii and iii.

c. Majority opinion:

        i. Under 16th Amendment gain must be **derived from** capital, labor, or both
        ii. Shareholder derives nothing from corporation by virtue of stock dividend
        iii. More similarity between i and ii than ii and iii – substance over form
        iv. Difference btwn partnership and corporate stockholder is not merely a formal distinction b/c partner has right to dissolution on demand and shareholder has no right to money on demand, only has right to persist
            1. Treasury Reg. §1.451-2 Constructive Receipt Doctrine: Tax constructive receipt when the person could have demanded the money any time they wanted
    d. Minority response:
        i. ii and iii are too similar to draw line between them, undistributed corporate profits are like partnership profits that are taxable
        ii. Similarity between all options is too strong a assert a constitutionally mandated definition of income – Congress can draw the line
        iii. Grant of power to tax to Congress includes inherent power to define income within reasonable limits; Court must decide if reasonable
            1. *Sanford and Brooks* – Court allows Congress to define income rather than making all tax cases issue of Con Law
    e. Realization is a timing rule - Macomber grants deferral only, profits taxed as gain on sale.
    f. Congressional Responses to Macomber
        i. Congress codified decision in Macomber (had to codify b/c ConLaw decision) using "derived from" language in §61(a)(3) definition of gross income and "sale or other disposition" in §1001(a) recognition of gain
        ii. §305(a) codifies decision by making optional stock dividends taxable and pure stock distributions untaxable
            1. §305(b)(2) If distribution changes proportional interest – taxable
        iii. §307 Basis of divided stock: Original investment in stock distributed evenly over all stock in hand to determine future gain

II. Tax Policy and Realization
    a. Arguments for Realization Policy
        i. Administrative Convenience:
            1. Taxing unrealized property would require the appraisal of property and gain every year; appraisals bring disputes
                a. Taxing realized gain obviates need for annual valuation
            2. Only two items present unrealized gain: stock and real estate
                a. Stock has active market, value is easily ascertained
                b. Real Estate and closely held corps are more problematic b/c they are not fungible with active market
                    i. RE valued every year w/ state property tax regime
                    ii. Closely held companies are real problem b/c no active market and no system of appraisal
        ii. Liquidity Problems: Imposing tax could require people to sell property in order to liquidate cash to pay tax; TPs have range of available liquid assets
    b. Arguments against realization policy
        i. Horizontal Equity: Growth and income stocks treated differently in tax

        ii. Economic Neutrality: Incentive to buy growth stock rather than income stock b/c growth stock offers tax advantage
            1. Massive investment in growth stocks which gives smaller return and misallocates resources for less productive society
        iii. Vertical Equity: Top 1% of wealth and income receive almost all of tax deferral benefits
            1. Only those who can afford reinvestment can afford deferral – unique benefit only available to those who don't need money
            2. Payment of tax only when TP chooses to pay
    c. Board of Directors' love this doctrine b/c it gives an excuse to hold on to money

III. When is income Realized
    a. *Helvering v. Bruun* – TP leased land and building for 99 years, demolished building and constructed new one, then forfeited lease for nonpayment of rent. TP took possession with new building w/ $51K greater FMV than original
        i. Court finds that value of building is taxable on year of lease termination
        ii. Profit realized when transaction is over and TP has full control over increased value – gives Congress power to tax
            1. Not about physical severance, it is about severance from the underlying risk of investment
            2. Economic gain need not be in cash derived to be realized:gain may be realized as result of exchange of property, payment of TP's indebtedness, relief from liability, or completion of transaction
        iii. Although value increase is accrued capital which is not taxed, conjunction of value increase and end of transaction makes it a realized gain
    b. Possible methods of taxing income from lessee improvements – methods are merely a matter of timing because adjusted basis will compensate for differences in paid tax at the sale of building
        i. Post-paid rent – landlord has income on termination of lease in amount equal to then prevailing FMV of building
        ii. Pre-paid rent – Landlord has income in year building completed in amount equal to predicted FMV of building on lease termination, discounted to present value
        iii. Pro-rata rent – Landlord has income each year from building competion to end of lease term in amount equal to predicted FMV of building on lease termination divided by number of years remaining on lease
        iv. No Rent – Landlord has no income at any time during the lease
    c. Congressional Reaction to Bruun – legislated due to severe finances in depression
        i. Congress told by Supreme Court that they have power to tax new building on termination of lease, but they decide not to tax – No rent option above
        ii. §109 – rejects the taxation imposed in Bruun, but uses language that recognizes their power to tax: "GI does not include income derived by lessor on term of lease"
            1. GI does not include income **other than rent**
                a. Landlord obligation triggered at completion of building when the nature of the income is rent

            b. When tenant builds in lieu of rent, rent is in kind rather than cash and must be taxed – Old Colony
                i. Reality of situation must determine tax treatment
                ii. Unclear boundaries for this determination
    iii. §1019 – There is no adjustment of basis due to income derived from lessor on the term of lease if it is untaxed under §109
        1. Preserves basis - exclusion of §109 is deferral not forgiveness
d. *Cottage Savings Ass'n* (1991) – Savings and Loan exchanged interests in order to realize loss deduction of $2.4M. IRS argues that exchange is not realization event because it is not "other disposition" under §1001 (vague due to ConLaw issue)
    i. Court holds that exchange is realization event only if there is "material difference" in properties exchanged upholding Treasury definition
        1. Material difference – "legal entitlements that are different in kind or extent" or "legally distinct entitlements"
            a. In corporate reorganization stock swaps materially different
            b. Exchange of loans secured by different properties are materially different – "underlying risk"
        2. IRS arguments for expansive view of materially different make much of §1031 surplusage
    ii. Court implicitly tells Congress: **realization is not an issue of ConLaw**

IV. Application of realization, recognition, and basis rules
    a. Gain = Amount realized – Adjusted basis, §1001(a)
        i. Gain taxed only on "sale or other distribution of property" - realization
            1. Other disposition not defined b/c Eisner made it ConLaw issue
            2. Bruun defines realization event as when the owner severs himself from the underlying risk of the investment
                a. Trade of property is realization event
        ii. Amount realized = Cash receiv'd + FMV in kind(total proceeds), §1001(b)
        iii. Adjusted Basis- **remaining tax-paid investment in property at any time**
            1. Adjusted basis of the new property received in an exchange = the adjusted basis of the property exchanged in the trade – cash received in the trade + any recognized gain – any recognized loss
            2. Depreciation - adjusted basis divided by projected useful life of property, lowers the adjusted basis
            3. Increased FMV that is taxed is returned over useful life so when useful life ends there is no tax on non-existing increase in value
    b. Realized Gain is not always recognized as Gross Income: **Nonrecognition**
        i. §1031 does not recognize gain if certain conditions are met
            1. Must be on the exchange of property (rather than cash sale)
            2. Old property was held for productive use in trade or business or other production of income (investment property not home)
            3. Must be sold for property of a like kind
                a. Treasury Reg. §1.1031(a) -1(b) treats all realty as like kind
                b. US property not like kind w/ foreign property, §1031(h)(1)
            4. New property must be used in trade or business or prod. of income

ii. Formula: Adjusted basis of the new property received in an exchange = the adjusted basis of the property exchanged in the trade – cash received in the trade + any recognized gain – any recognized loss
    1. Tax deferral only because this formula preserves the amount of capital invested in an investment originally
    2. Function of bais is to continually track unrecovered tax-paid investment to provide accurate measure of enrichment
        a. What would happen if person sold the day after trade

iii. When nonrecognition does not apply because of an exception or failure to meet 4 conditions fall back on general rule that al realized gain is taxed
    1. Exceptions to nonrecognition: stocks, inventory or other property held primarily for sale (land for development, sale), indentures and securities, interest in partnership, certificates of trust, §1031(a)(2)

c. Steps for calculation
    i. To calculate the sale proceeds independent parties acting at arm's length are expected and assumed to trade a equal value
    ii. Separate the two parties of the transaction for individual calculations
        1. Nonrecognition rule (§1031) applies independently to each party
    iii. Calculate realized gain based on assumed equal trade value
        1. Never look at nonrecognition until realized gain is calculated
    iv. Determine whether gain is recognized under 4 §1031
        1. 4 conditions must be met for nonrecognition
        2. Check exceptions to nonrecognition
    v. If nonrecognition determine the adjusted basis of new property
        1. AB old property – cash + recognized gain – recognized loss

V. Policy and Rules of Nonrecognition under §1031– compounding unfairness of Eisner
    a. Policy behind §1031
        i. Administrative Convenience: Avoid valuation controversies, FMV inherently disputable
            1. Wait until we actually know value in cash received and then tax
        ii. Taxpayer compliance: TP may not have cash to pay tax –liquidity concern
            1. Convenience in timing liability important to perceptions of fairness
        iii. Horizontal Equity: Unfair to tax if no substantial change in investment even if there is a technical realization event.
            1. Compare swap of property to continued holding of property where unrealized gains get continued tax deferral
        iv. Economic Neutrality: Avoid capital lock-in effect
            1. Even another investment is better according to market, tax requirements will deter individual from making switch when tax paid makes amount available for reinvestment less than value of staying w/ current investment
                a. Can't fully explain b/c argument also applies to stock exchanges where we have recognition
        v. Justified by combination of these reasons, but nothing completely answers problem; solution is to eliminate realization doctrine that creates problem
    b. The "boot" rule – non like kind property treated as cash received

        i. Gain is taxed up to the FMV of cash or not-like kind property received
            1. Example: $400K basis property traded for property valued at $350K and $100K in building materials
                a. Realized gain = $50K, recognize up to $100K
                b. New Basis = $400K - $100K (cash received) + $50K recognized gain - $0 recognized loss = $350K
        ii. To the extent that TP withdraws from similar investment, Congress withdraws tax deferral privilege
    c. Loss is never recognized in an exchange if you receive boot (property not of a like kind) along with property of a like kind
        i. Property never exchanged for a loss because this defers a deduction which taxpayers do not like
            1. Competently advised taxpayers will sell property then purchase new property so that loss can be recognized
        ii. Government does not recognize loss b/c realization is completely controlled by TP and TP is in win/win situation
            1. Congress at least forces complete bail out of investment for loss
    d. Properties of a "like kind"
        i. Real property w/in US is always considered property of like kind
        ii. Treas. Reg. §1.1031(a)-2(b): **Depreciable, tangible** personal property is of like kind if it is in same asset or product class
            1. General Asset Classes: office furniture, information systems, autos
        iii. Court has ruled that nondepreciable property such as patents are of like kind when the underlying nature and risk of investment are the same
            1. Facts and circumstances determine underlying risk of invest
            2. See exchange of gold pieces CB273
    e. Deferred exchanges: use of K to get other party to buy property and exchange
        i. Treasury didn't allow because contractual rights and property not like kind
        ii. Congressional response: §1031(a)(3) establishes limited time period for acceptable exchanges

VI. Nonrecognition for compulsory or involuntary conversion §1033
    a. §1033 – If property is compulsorily or involuntarily converted into "property similar or related in service or use", no gain is recognized
        i. Similarity of service or use of property loss determined by functional test
            1. Can argue that functional use of property is different based on different developments (ie housing and golf course, golf course may be different than original plans for housing only)
            2. Can argue similarity in function to developer – both for sale
        ii. Functional standard more narrow than real estate under §1031. Narrower standard appropriate because many of the justifications for nonrecognition do not apply – only horizontal equity applicable
            1. Administrative convenience: no valuation controversy, TP got cash (court already valued at condemnation proceeding)
            2. Taxpayer compliance: No liquidity concerns b/c TP got cash
            3. Economic Neutrality: No capital lock-in b/c govt. forced you out of investment

            4. Horizontal Equity: Unfairness in comparison to tax deferral accorded to unrealized appreciation particularly acute b/c TP did not make the decision to get out of investment
        iii. Special rule overrides functional standard and time period when property used in trade or business is taken
            1. When real property for productive use in trade or business is taken, property of "like kind" (§1031 standard) is "property similar or related in service or use"
            2. When business property is taken then end of time 3 yrs not 2
    b. §1033(a)(2) – For nonrecognition when involuntary conversion into cash or dissimilar property, similar property must be purchased w/in specified time
        i. Nonrecognition period begins at time of conversion OR the earliest date of the threat or imminence of requisition or condemnation of property, whichever is earlier
        ii. Nonrecognition period ends 2 years after the close of the taxable year in which any part of the gain is realized
    c. Differences between §§1031 and 1033
        i. §1031 doesn't apply to eminent domain or other involuntary conversion b/c cash is received
        ii. Involuntary conversion may not be under §1031 if plans include development for sale rather than investment b/c of inventory exception
        iii. §1033 Can apply to cash sale and reinvestment
        iv. §1033 Can apply to personal consumption property
        v. §1033 is elective rather than compulsory
    d. If §1033 applies gain shall only be recognized to the extent that amount realized on the conversion exceeds the cost of replacement property
        i. Example: paid \$1.5M, \$1.2M reinvested in property "similar or related in service or use," then immediately taxed on \$300K
            1. Basis = Cost of replacement property – unrecognized gain
            2. If example had basis of 1M, then basis = \$1.2M - \$200K = \$1M
        ii. Taxed on amount withdrawn from type of investment, fair to tax this gain
            1. Same concept as §1031 boot rule

VII. Tax Forgiveness for Sale of home under §121
    a. §121 excludes \$250K (\$500K for married if (a)(2)(A) is met) of realized gain for residential property
    b. There is no basis rule under §121 so the basis is the cost of the new property
        i. Tax forgiveness rather than deferral b/c we do not save untaxed gain
    c. Justification
        i. Historically §1034 was nonrecognition provision and §121 was a one time grant for elderly that allowed them to use before tax forgiveness of death
            1. This was justified by involuntary nature of many moves
            2. Also former treatment justified by capital lock in effect
        ii. 1997 Congress repealed §1034 and removed one time aspect of §121 forgiving tax on housing investment
            1. Change justified b/c deferral and basis too complex for average joe
            2. Also justified b/c many have only nonrecognized gain in home

d. §121 Creates a perverse incentive to move every time a home reaches gain of $250/$500 even though you would rather live there for life b/c tax forgiven and investment can continue to grow with protection for another $250/$500
e. Property must have been used as home w/in last 5 years
f. Forgiveness only allowed once every two years

VIII. The Proper Taxpayer: Loss disallowance for sale between family members: §267 renders loss nondeductible for the sale or exchange of property directly or indirectly between members of families, corporations controlled by same entity, etc.

a. To be able to claim a deduction TP must be able to point to explicit statutory authorization that allows it, AND there must be no section that disallows it
    i. §161 says that allowance of deductions is subject to exceptions meaning that disallowance overrules any statutory allowance
    ii. §165 allows deduction for loss "sustained during the taxable year"
        1. Must be realized and completed transaction in the taxable year evidenced by identifiable events. Treas. Reg. §1.165-1(b)
        2. §165 overridden by §267
b. Basis of property when loss disallowed under §267
    i. Nothing in §267 mentions basis, so default rule §1012 applies
    ii. Basis is determined by cost; thus, loss disallowed rather than deferred
        1. Harsh rule b/c it would allow loss even though family still has investment and transfer of loss would allow loss shifting w/in family to the person in the highest tax bracket
        2. Proper rule of holding loss in abeyance for the original owner would be too hard to administer
c. Congress allows the buyer of stock w/in a family transaction to only recognize the gain in excess of the original investment
    i. Original purchase $100, sale to brother $70, final sale by brother $150, Gain = $5 even though brother realized $35
d. Definition of terms within the rule
    i. Definition of family for suspect transaction does not include in laws §267(c)(4)
    ii. Directly or indirectly language disallows loss if sale is achieved through intermediary such as selling to market while brother buys from market
e. Concern of §267 for the proper taxpayer is illustrated by §1091
    i. §1091 does not allow a deduction when stock is sold and then repurchased w/in 31 days on either side of the transaction
    ii. Although no deduction is immediately allowed, basis = cost of new stock + the disallowed loss which preserves the loss – deferral

IX. Realization and Capital Gains and Losses

a. Preferential Treatment of Long-term Capital Gains
    i. §1(h) progressive rate schedule applies to income other than capital gains
        1. Special rate schedule for capital gains
        2. Generally taxed at 15% rather than progressive rate
    ii. §1221 defines capital asset a property held for taxpayer excluding inventory, depreciable property, real property for business, a copyright, accounts or notes receivable, etc. – extraordinarily broad

iii. §1222 If you sell capital asset for gain you have capital gain
   1. Long term if held for more than 1 year, short term otherwise

b. Justifications for reduced rates of capital gains
   i. A lot of capital gain increase in value not increase in wealth, its inflation
      1. This reflects a problem in code's definition of gain b/c entire code defines gain as comparison of historical value to current value
      2. Lower capital gain rate is not solution b/c same tax rate applies regardless of length of holding and amount of inflation
         a. Complexity stops the indexing of goods by inflation %
   ii. Vertical equity concern: Bunching of income
      1. Realization doctrine takes gains from long period of time and taxes for single year, bringing higher tax bracket than deserved
      2. Lower capital gains is not solution b/c reduced rate is not affected by number of years held
   iii. Mitigation of capital lock-in: bribe people to take gains when property holders can't afford or don't want to pay tax on substantial gains
      1. Problem caused by realization doctrine, exacerbated by horizontal equity concerns that brings nonrecognition
      2. Full olution is to either eliminate realization requirement or tax capital gains at zero
      3. Short of these Congress chose to mitigate capital lock-in
         a. Compromise btwn full tax and general nonrecognition rule
      4. This is only justification that actually solves the problem

c. Limited deductibility for capital losses, §§165(f) – loss deduction sec., 1211, 1212
   i. §165(c) only allows individual to deduct losses if incurred in business or incurred in transaction for profit or incurred from fire, storm, theft, etc.
   ii. §1211 Capital losses only deductible for individual against capital gains and $3K/yr against ordinary income
   iii. §1212 capital losses carried over indefinitely so that they are non-deductible so that they can be offset against gains in future years
      1. Every year $3K against ordinary income
   iv. Policy behind capital loss provisions
      1. Since TP controls when she/he has capital losses and gains, Congress limits the amount losses can be claimed
      2. Encourages contemporaneous loss and gain
   v. Problem is realization doctrine

d. Revenue lost from reduced capital gains tax is almost third most costly to govt. as compared to theoretically sound income tax, behind retirement and health care

Income by discharge of indebtedness and liability

I. Scope of Loan Tax Treatment
   a. Income tax treatment of loans
      i. Proceeds are not income b/c there is equal liability
      ii. Principle payments are not deductible
      iii. Debt forgiveness is then income
   b. Defining a loan for income tax purposes
      i. Loans typically entail unconditional consensual obligation to repay in full

        1. Promise of gift does not get this treatment b/c TP did not receive anything of value for promise, release from promise not income
            a. Alternatively release can be seen as gift back from recipient
        2. No discharge of indebtedness income when there is a dispute about extent of the debt b/c no bona fide liability followed by discharge
    ii. Conditional repayment obligations have individualized treatment
        1. Claim of Right Doctrine
        2. Embezzlement
        3. Nonrecourse loans

II. Discharge of indebtedness as income
- a. *Kirby Lumber* – Kirby issued bonds (loan contracts) and was able to repurchase for $138K less due to intervening rise in interest rates
    - i. Court found that discharge of indebtedness was income
        1. Loans are not income b/c cash received has an equal and offsetting obligation to pay, liability
        2. Discharge of indebtedness for less than amount paid is enrichment
    - ii. Congress codified *Kirby Lumber* in §61(a)(12), but ambiguity in rational
- b. Two plausible rationales behind Kirby Lumber correspond to different treatments of discharge of indebtedness in insolvency
    - i. Insolvency exception: originally courts held that there is no income if debtor is insolvent before and after discharge of indebtedness
        1. Debtor could default and go bankrupt, creditors would have nothing - they lower liability, but there is no enrichment of debtor
        2. Even though liability reduced none of debtor's assets freed if debtor is insolvent on both sides of transaction
        3. Counterargument: corporations reorganize rather than liquidate b/c management believes they can return to profitability and creditors believe they can get more if they pull the plug
            - a. Business behavior proves that there is value in liability reduction even if insolvent on both sides of transaction
            - b. To extent liability reduced, debtor's prospects improved
    - ii. Enrichment rationale: Income b/c individual enriched by discharge, some assets freed from claims of creditors
        1. Focus on debtors total financial situation
        2. Insolvency exception applicable b/c none of the debtor's assets are completely freed from claims of creditors
    - iii. 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 insofar as the offsetting liability
        1. Extension of the inclusionary side of the Tax Benefit Rule – discharge as income is error correction mechanism
        2. Looks at loan in isolation, debtor profits by transaction no matter if insolvent or not
- c. §108 Current treatment of discharge of indebtedness
    - i. Income is gained through the discharge of indebtedness

ii. Code provides separate exclusion for income when discharge occurs during bankruptcy or to the extent of insolvency
    1. To the extent that discharge makes a party solvent, the party is taxable immediately on the income above solvency, §108(a)(3)
iii. §108(b) – discharge reduces the amount of deductions which could have been carried forward through Net Operating Losses
    1. If NOL is zero gain will be carried over through business credit, minimum tax credit, capital loss carryover, basis reduction, etc.
iv. Adopts recapture rationale w/ concession for fact that govt. does not want to tax when an individual doesn't have money, making situation worse
    1. Insolvency exclusion is deferral rather than forgiveness
    2. Inappropriate to tax now, but liability will be saved for later
v. Nonrecognition rule masquerading as exception – like §109
vi. Adjustments to disputed bills are not treated as discharge of indebtedness

d. *Zarin* – Gambler loses credited money and fails to repay. Settlement for $2.9M less than "loaned" amount when Zarin denies liability based on unenfoceability
   i. Horizontal equity with gambler who takes bank loan to finance habit and gambler who repays in full suggests that Zarin should have tax liaibility
      1. Zarin received value either in chips when credited or at discharge
      2. Not a purchase price adjustment (§108(e)(5)) b/c this section was intended for good faith disputes over product quality or worthwhileness of the service
   ii. Really a scrambled transaction on loan and the use of proceeds
      1. Proper treatment wouldn't deduct of gambling loss against loan income b/c gambling losses only deductible against winnings
      2. Recapture rationale does not consider situation of the individual
   iii. Purchase price adjustment may be the correct analysis in the end b/c purchase price of gambling "chips" is determined by risk
      1. Zarin is known compulsive gambler so there is no risk of loss for the casino; thus, the price of chips would be less
      2. Unique facts make purchase price adjustment a worthy argument

III. Money is received without unconditional offsetting claim is income
   a. *North American Oil* – US contested TP's right to oil deposits and profits held. 1917 profits given to oil company based on victory in trial, US appealed – suit completely resolved in 1922.
      i. §451 – Income properly reportable according to TPs method of accounting
         1. Accrual method – accurate method used by business (§446)
            a. Income when all events have occurred that fix right to receive $ and amount determinable w/ reasonable accuracy
            b. Deduction when
               i. All events occurred that establish liability
               ii. Amount determinable w/ reasonable accuracy
               iii. Economic performance occurs
         2. Cash Receipts and Disbursements method – used most
            a. Report income when received

                i. Constructive receipt doctrine, Treas Reg. §1.1451-1(a): If TP could have received and there are no substantial limitations then it is considered received
            b. Report deduction when expense paid
        ii. Under either method receipt of money constitutes income
            1. TP argues that liability in appeal created offsetting claim so that loan treatment is proper
            2. Offsetting claim is not unconditional, N.A. Oil even claims that the money is theirs in separate trial– loan not appropriate
    b. Claim of right doctrine: "If TP receives earnings under a claim of right and w/o restrictions to its disposition it must be reported as income, even though there may be asserted offsetting claims and may even be forced to ultimately repay"
        i. Deductions allowed as error correction mechanism if money paid back
        ii. IRS can't administer rule that calculates income with probability of offsetting liability
        iii. If no claim of right, TP could defer income (loan treatment) based on the possibility of any claim even though TP neither wants nor expects claim

IV. Equitable Relief when rate changes combined w/ error correction leave TP unwhole
    a. *US v. Lewis* – employee paid bonus of $22K and then must repay $11K due to employer mistaken computation
        i. Under claim of right doctrine Lewis never acknowledges that money is not his; thus, he has claim and possession which means he must report
        ii. When Lewis repays $ he is granted a deduction for overpayment, but intervening rate change made the deduction worth less
        iii. Court rules that Congress screwed him and tax must be calculated yearly
    b. Congress responds w/ §1341 which reduces the amount of tax paid in year of error correction (repayment) by amount of extra taxes paid when item received under claim of right
        i. TP given choice to claim deduction in tax based on disenrichment (if rates higher now) OR exclude the amount of previous overpayment on taxes
        ii. Theoretically should have given the amount of previous overpayment

V. Embezzlement
    a. Court originally held embezzler is entitled to loan treatment b/c funds not held under a claim of right and embezzler subject to unconditional obligation to repay
        i. Led to defense of tax evasion by claiming the money was embezzled
    b. *James v. US*
        i. As a matter of tax policy cannot treat like loan even though there is obligation to repay b/c repayment is extremely unlikely
        ii. No legal contingency, but debt is subject to factual contingencies
    c. *McKinney* - Reports illegal income then after repayment claims deduction
        i. Govt. grants deduction, but does not allow carryover of excess deduction
        ii. §172 does not apply b/c deduction not for trade or business

VI. Debt and Basis for Nonrecourse Loans
    a. The basics of debt and basis calculation
        i. Basis equals cost and cost of loan to obtain does not affect collateral basis

    ii. Capital expenditure for improvement can change basis, but loans used to achieve this capital expenditure have no affect on basis of the property
    iii. 3d party satisfaction of loan obligation is treated as income - Old Colony
        1. If buyer pays TP $1.2M for house or pays $0.2M and takes over a $1M loan the results for income are the same
        2. Amount realized must include total value received in consideration for transfer of property whether received as cash, other property, services, debt relief, or combination thereof (change def. above)

b. Nonrecourse loans – loans where the borrower is not liable for the deficiency in collateral value
    i. Amount realized in sale of property with nonrecourse loan must include the amount of loan taken over, plus the cash value received: *Crane*
        1. Theoretically: While the borrower does not have offsetting liability to make discharge of indebtedness income, the only way for borrower to receive equity value is to pay loan or sell and trap new owners equity in loan.
            a. In essence this means that payment in full or promise to pay debt plus the difference in value are still economically equivalent even though the loan is nonrecourse
        2. Technically: adjusted basis includes amount of money obtained through nonrecourse loan so the amount realized must also
    ii. *Tufts*: Mortgage Principal Value = $1.85M; Collateral FMV = $1.4M; Adjusted Basis = $1.46M. TP claimed loss of $60K on sale, but IRS asserted gain of $390K on sale
        1. Theoretically correct response: Tufts is not enriched by disposition of collateral, but when we unscramble loan transaction and gain from discharge of indebtedness there is a $390K gain
            a. $450 ordinary income from discharge of indebtedness - $60K long term capital loss on property = $390K gain
            b. Gain characterized as ordinary income
        2. Nonrecourse loan treatment by Tufts: Total amount of outstanding nonrecourse loan is "deemed" amount realized, from that you subtract the adjusted basis to get the gain
            a. $1.85M "deemed" amount realized – $1.46M adjusted basis = $390K gain
            b. Gain characterized as long term capital gain
        3. Court failed to properly unscramble the transaction
            a. Same amount of gain
            b. Different characterization of gain
    iii. Congress codified Tufts even though it was theoretically incorrect and the theoretically correct treatment was recognized by O'Connor
        1. Bottom line – amount realized on disposition of property includes amount of any nonrecourse liability to which property is subject
        2. Additionally amount realized includes any obligations assumed or paid in connection with the transaction as always.

c. Nonrecourse loans have an important factual contingency like the claim of right or embezzlement cases that did not receive loan treatment, nonetheless nonrecourse loans are given loan treatment rather than cash flow treatment. This is due to factually unusual situation where nonrecourse obligations are not repaid
    i. Tufts and Zarin both borrowed, used money to gamble and didn't pay money back
    ii. Unlike Kirby Lumber both of these cases lost money which was reflected by allowable deductions
    iii. Tufts got the full value of his bet because he could have won, but Zarin did not because as compulsive gambler he could not have won

Gifts and Income Tax Policy

I. Tax Treatment of Gifts
  a. Theoretically Correct income tax treatment of gifts
    i. Donee should be taxed b/c there is increase in amount available for consumption or savings
    ii. Donor taxed on income when received: two perspectives for treatment
      1. Material consumption: Donor should get a deduction b/c once property given away it is not available for consumption or saving
      2. Intangible consumption: Donor should not get deduction b/c they chose to make gift which demonstrates that giving was valued more than additional consumption – intangible satisfaction
        a. Donor and donee taxed b/c consumption never deductible
        b. Requires donee to include value of gift w/o deduction taken by donor
  b. §102 – Excludes gifts from the income of recipient and does not give deduction to the donor (only applies to money gifts, not property §1015 or charitable gifts)
    i. Donor taxed b/c of administrative problems w/ theoretical positions
      1. Under material consumption focus there is potential tax evasion via unjustified income shifting
        a. Donee taxed at reduced rate makes incentive to "give" property to child which will be eventually used toward the donor's consumption
        b. *Disguised consumption problem*
      2. Under intangible consumption there is tax evasion through concealment
        a. Donor would not be allowed deductions, IRS wouldn't find out about gift
        b. Only voluntary compliance turns into tax on honesty
    ii. Taxing donor only avoids problems with theoretical positions
      1. Donor tax administrable substitute for donee tax, to protect the integrity of progressive rates. Material consumption idea
      2. Donor tax is actual result of taxing both under intangible consumption view – donee tax unenforceable
  c. §102(b)(1+2) – [codifies of *Gavitt*] income gained from gift property is income
    i. When gift is given all income earned from the gift is taxed
    ii. Income portion of a gift of split interests is taxed

            1. Trust given to kid, interest to parent until age – tax parent portion
            2. Life tenant gets taxed on everything while remainderman gets property tax free
        iii. Contrast with tax treatment of purchased split interest
            1. Purchaser of life estate has basis and is permitted to deduct that basis pro-rata over estimated life of the life estate?
            2. Donee does not get depreciation deduction or exclusion for property to ensure that income on property is taxed
    d. *Early* (1971) – Elderly client signs over stock worth $2.3M to TP his accountant and when client dies estate challenges the gift. TP settles for life interest in trust
        i. If Early is purchaser he gets offsetting depreciation, if gift no depreciation
        ii. Because disputed entitlement and settlement are not independent events, there was no trade of interests and the life estate was a gift
    e. If a life tenant sells an interest in a trust then the adjusted basis is zero and every penny is taxable in full which is consistent w/ treatment of life interest in §273

II. Gifts of appreciated property - §1015
    a. Theoretical treatment of basis for gift property
        i. Material consumption: donor receives nothing on transfer – no tax
        ii. Intangible consumption: donor receives emotional satisfaction – realization of income by gift bequest, so tax donor on appreciation at gift
        iii. Code doesn't treat gift as realization event and donee excludes under §102
    b. If TP gives appreciated property the appreciation does not escape tax completely because the basis is preserved under §1015 Transferred basis rule
        i. Tax deferral and transfer with the gift
        ii. Taxed to wrong person (almost always lower rate) at wrong time
        iii. If gift of $16 dollars w/ basis of $10 is sold at $15 by the recipient, the recipient is taxed on $5 of income because basis is preserved
    c. Exception clause of §1015: If basis of gift is greater than the FMV of the property at the time of the gift then the purpose **for determining loss** shall be the FMV
        i. If gift finally sold at price greater than basis, gain determined by basis
        ii. If gift sold at price less than FMV at time of gift, loss determined by FMV
        iii. If gift sold at any point between original basis and FMV at time of gift, then we have neither gain nor loss under the statute
    d. §1015 treats gains and losses differently b/c disposition w/in control of TP and Congress needs to slow win-win possibilities
        i. Separate rules stops the "giving" of losses to higher tax bracket
        ii. §267 disallows loss in sale to family member for same reason
    e. Even if §1015 taxes the wrong person at wrong time – Congress wants to tax appreciation eventually to someone

III. Property Acquired from Decedents
    a. Tax treatment of decedent and recipient at time of death/transfer is exactly like taxes on gift (no tax to either), but §1014 grants a basis = FMV at time of transfer
        i. §1014 does not preserve gain or loss prior to death
        ii. Outright tax forgiveness of any unrealized appreciation b/c basis not preserved and obliteration of any losses, not deductible to either party
    b. Under §1014 wealthy elderly clients advised to sell all property at a loss

        i. §1014 only grants basis of FMV for gains b/c no competently advised individuals die with property that has loses
        ii. Referred to as stepped up basis rule, not FMV basis rule
        iii. Converts deferral inherent in realization into tax forgiveness, greatly increasing tax preference for wealthy
    c. IRS applies nonrecognition rules very strictly b/c if appreciation is not taxed now it may never be taxed due to this rule
    d. §1014 Tax Policy Justification
        i. Concern for double taxation – both income tax and estate tax
            1. Double tax inherent in estate tax
            2. Concern misplaced, it is objection to estate tax
        ii. Liquidity Concern – convenience in time of tax payment
            1. Don't want to force sale of family prop. to pay tax on appreciation
            2. Transferred basis rule such as §1015 would solve this problem
        iii. Capital Lock-In – FMV basis to donee eliminates capital asset freeze in
            1. Transferred basis would keep property in hands of children rather than allow them to sell and get out of family business
            2. Tendency to hold onto property is eliminated if we forgive tax, but this is rather extreme approach
            3. Realization at death would solve capital lock-in
        iv. No social policy justifications
    e. How to fix death time tax forgiveness
        i. The problem
            1. Liquidity suggests transferred basis, but that exacerbates capital
            2. Realization at death eliminates lock-in, but would force liquidations and wide spread TP resentment
            3. Contradictory solutions have lead to long-term policy paralysis
        ii. Realization at death, with multi-year installment payments of tax liability allows beneficiaries to pay tax liability with gain from property received over a period of time
    f. §1022 - Transfer of Property for decedent dying after Dec. 31, 2009
        i. Property acquired under rule treated as gift w/ transferred basis like 1015
        ii. Transferred basis subject to a basis increase of up to $4.3M
            1. Near wealthy will never suffer any taxation under this rule
            2. Even wealthy will be able to avoid to some degree
        iii. Section to go into effect at the same time the estate tax is to be repealed, many believe it will never happen
    g. Tax amounts collected as ordinary income to decedent's estate treated as ordinary income taxable to whomever has legal right to fees at death. §1014(c), 691

IV. Defining a Gift for Income Tax Purposes
    a. *Duberstein*
        i. Whether transfer proceeds primarily from 1) constraining force of legal or moral obligation or anticipation of future benefit (not gift) versus 2) detached and disinterested generosity (gift).
        ii. Mixed personal and business transaction court uses a primary purpose test

1. Unscrambling requires knowing more about a relationship than objective information allows
2. Whenever possible unscramble transactions, but when we cannot unscramble we use all or nothing primary purpose test.
3. Weight given to fact finder in primary purpose test: fact dependent

iii. Primary purpose depends on motivation of donor, but tax consequences are relevant to the recipient who doesn't know donor motivation

b. Congressional Response to *Duberstein*

i. §274 – If gift is more than $25 no deductions allowed under §162 or 212
   1. Can't take deduction and allow tax free receipt; thus, no deduction
   2. Either transferor or transferee will have to pay tax

ii. Statute uses term excludible rather than excluded which allows transferor to claim the deduction and say it was not a gift, while recipient will claim it was a gift and not claim income
   1. IRS questions donor first- if employer deducts it will defend the deduction by saying that primary motive is business
   2. Testimony will indicate the primary purpose used against donee

iii. §102(c) – In 1986 Congress declares that there are no gifts from employer to employee

iv. Combination of §102(c) and §274 very close to IRS proposed bright line rule in *Duberstein*.

c. Gifts from an organization like a church or corporation

i. IRS will recharacterize as a gift from directors paid by the corporation b/c corporation cannot have feelings required for gift

ii. For tax purposes the gift is salary to the directors who then give gift

iii. Recharacterization of transaction as constructive dividend payment to shareholder followed by personal gift is common argument where corporation makes a payment that doesn't benefit corporation: often wins

Tax Treatment of Marriage and Divorce

I. Property Settlements

a. *Davis* – Property settlement called for periodic support payments to wife and transfer of 1000 shares of DuPont stock. Stock appreciated during husband's ownership such that 500 shares had FMV =$82K and adjusted basis of $75K

i. Transaction was a taxable realization event for Mr. Davis b/c Mr. used value of stock to purchase release of property claims
   1. Bailed out of investment completely – Bruun realization
   2. Mr. Davis received rights = to FMV b/c we assume even exchange in arm's length transaction
      a. Gain = FMV – Adjusted basis

ii. For Mrs. Davis property received is damage claim. Under Raytheon replacement rule damages could represent
   1. Future expected support in kind – tax free b/c would be taxed when earned by Mr. Davis
   2. Personal rights (loss of consortium) – tax free imputed income
   3. Expectancy of share of property if husband predeceases – GI does not include receipt of inheritance under §102 and 1014

            4. Divorce reparation damages nontaxable whatever they redress (But Congress shift this liability for alimony
        iii. Kresge case finds that prenuptial agreement exchange is advanced property settlement with tax free damages as well
    b. §1041 - Congressional (delayed) response to *Davis*
        i. §1041 grants nonrecognition of gain on the transfer of property to a spouse or former spouse incident to a divorce
            1. Gain is taxed to recipient on sale of transferred property
            2. Taxes at the wrong time (deferred) to the wrong person (normally recipient in divorce settlement will have lower tax bracket)
            3. Works just like §1015
        ii. Justification for §1041
            1. IRS getting whipsawed in divorce property settlements: wife took property tax free w/ FMV basis, but husbands not reporting sale
                a. Not deliberate tax evasion – divorced transaferors do not feel that settlement is sale/ realization event – **ignorant noncompliance**
                b. Treas. begs for nonrecognition b/c $ better late than never
                    i. Proper theoretical treatment not workable
            2. §1041 eliminates disparity in tax treatment of divorce property settlement between common law and community property states
    c. Divorce planning implications of §1041
        i. Spouse anticipated to be in lower tax bracket in future should receive the appreciated property to reduce the tax burden
            1. Less tax burden = more for everyone except the IRS
            2. If appreciated property is capital asset it may not matter
        ii. Unlike §1015 there is no special except clause for loss deductions; thus, depreciated property should go to higher tax bracket
    d. With §1041 Davis does not have any continued relevance in context of divorce; still stands for general proposition; **any transfer of property in satisfaction of a legal liability is a sale**

II. Alimony for tax purposes
    a. History of alimony
        i. Originally alimony excludable by payee and nondeductible by payor b/c substitute for non-taxable in-kind support
        ii. 1942 Congress shifted tax liability to payee b/c war and alimony % from salary left some husbands w/ nothing
        iii. *Bernatschke* (1966) – determined that annuity payments were property settlement rather than alimony on facts, intent of parties
    b. Alimony today §71, 215
        i. Prior law distinction btwn alimony and property settlement required intensive examination of facts to determine intent of parties and state law
            1. Unworkable on a mass scale
        ii. 5 criteria to establish alimony under bright line rules, easy to administer
            1. Must be in cash
                a. In kind §1041 – transferred basis and nonrecognition

2. Received by spouse under divorce or separation agreement
3. Must not designate the payments as otherwise §71(b)(1)(B)
    a. Parties can choose tax treatment that they want
    b. Default rule is for alimony treatment which is likely most beneficial b/c it shifts tax burden to lower bracket
4. Couple must be living separately
5. No liability to make payment after death of payee spouse

iii. 5 Criteria legislate form over substance and give TPs right to select most advantageous tax consequences w/o altering relationship
    1. Both §1041 and alimony rules give win-win over treasury

c. Alimony recapture – intended to distinguish periodic payments from settlement
    i. §71(f) – If w/in first three years the lump sum reduced by at least $15000, §71(f) reverses previous tax treatment
    ii. Easily evaded w/ proper tax planning by spreading settlement over 3 years

III. Child support
    a. Generally in cash to custodial parent, could meet alimony test and be deductible
    b. §71(c)(2) – If amount will be reduced on happening of contingency related to a child or at a time which can be clearly associated w/ such a contingency, then it is child support and payor is taxed, payee gets tax free
        i. Treas. Reg. §1.71-1T defines, "clearly associated" with contingency
            1. Payments reduced no more than 6 mo. before or after kid turns 18, 21, or the local majority
            2. Payments reduced on two or more occasions not more than one year before or after a child of payor spouse attains age 18-24
    c. Personal exemption deduction goes to parent w/ custody for more of year, unless written otherwise

Deductibility of Expenses, Personal vs. Business Expenses

I. The Standard for judging the deductibility of an expense
    a. In order to be deductible, expenses must meet test of §162 AND not fall into a disallowance of §262 or §263
        i. TP must prove that expense meets §162 – must point to statute
    b. §162 allows deduction of "ordinary and necessary expenses paid" in "carrying on" a trade or business
        i. Necessary in §162 and 212 means only "appropriate and helpful"
            1. Override common usage b/c business judgments best left to business people, "slow to override his judgment"
            2. IRS should not sit to review importance of costs or inhibit innovation – Congress couldn't mean to leave judgment to court
        ii. Ordinary is common usage according to the normal business activities
            1. Objective approach rather than taxpayer specific
                a. TP specific would give deduction for repetition
    c. *Helvering* – farmer whose corp went bankrupt voluntarily paid back debt. Court determines that expenses were not deductible b/c not "ordinary." 3 interpretations
        i. Failure to evidence commonality of expense; didn't meet burden of proof
            1. Suggests that could be deductible under §162 like advertising or cost of maintaining goodwill

- ii. Expenditures **acquire or improve** business reputation, do not maintain
  1. Disallowed by §263 as capital expenditure, purchase of goodwill
  2. Compare repair v. improvement problem: if repair deductible under §162, but if improvement deduction disallowed under §263
  3. Capital expenditure gets basis, but no immediate deduction
- iii. Expenditures maintain or improve **personal or social** reputation
  1. Disallowed by §262 as personal, living, or family expense
  2. May need to rebuild reputation for acceptance at social club

II. Cost of Education: Theoretical v. Actual treatment

- a. Education may constitute maintaining existing income producing skills
  - i. §162(a) – deductible b/c necessary (appropriate and helpful) and ordinary
  - ii. Continuing Professional Ed is deductible – theoretically correct
- b. Ed. may constitute purchase of new skills to produce income over future years
  - i. §263(a) – disallowance of deduction in present year b/c produces income over rest of career. Capital expense w/ poss. depreciation
  - ii. Actual - §263 properly doesn't allow deduction now, and §167 does not allow depreciation deduction over the life of career
    1. Skills are not property subject to depreciation
    2. No deduction for loss b/c skills are non-transferable
- c. Ed. may constitute entertainment or recreation (arts and crafts or sports courses)
  - i. Never deductible – theoretically correct (doesn't meet §162)
- d. Current treatment in sum
  - i. Expenses deductible if they
    1. Maintain or improve skills for current employment
    2. OR meet express requirements for retaining TP position at pay rate
  - ii. BUT they become undeductible if
    1. Necessary to meet minimum ed. requirements for employment
    2. Qualifies TP for new trade or business
  - iii. §274 bars deduction of costs of attending seminars outside North America or on cruise ships

III. Expenditures and Tax Policy: Theoretically correct treatment of expenses

- a. Net income = GI – Expenses of Production = Consumption + ΔWealth
  - i. Consumption is core of tax base and is never deductible, §263
  - ii. Current capital expenditures disallowed b/c they are for production of income in future, but not NOW, §263 Savings not deductible
    1. Merely conversions of form of wealth into resources rather than disenrichment
    2. ROC and depreciation later
- b. Dissaving may be attributable to
  - i. Voluntary use of resources for consumption §262 [positive consumption but negative Δwealth cancels out for no adjustment to net income]
  - ii. True disenrichment, §165
- c. Current expenses and depreciation deductible NOW, but change in wealth to resources for future production of income get ROC later
- d. Personal, living, and family expenses are never deductible, §262
- e. There are exceptions to the idea that consumption is the core of the tax base

i. Consumption is deductible for mortgage, property taxes, and certain types of savings that produce income over future years (IRA, 401K)
ii. Income tax is turning into consumption tax by allowing more deductions for savings