FEDERAL INCOME TAX OUTLINE – WIEDENBECK – SP 2007

Statutory Interpretation and Policies

I. Statutory Interpretation
   A. First, look for statutory definitions
      1. Could be defined within the subsection you are interpreting or related sections
         a. NOTE: Always check all cross references
      2. Could be defined in the gen'l statutory definitions in **§7701**, which apply to the entire IRC
   B. Second, look to common usage: If Congress didn't define a term then likely they meant to use the customary meaning attached by society.
      1. This is the gen'l fallback of courts when term in not defined.
   C. Third, look to policy behind the statute.
      1. If policy is clear, that policy should be effectuated even if contrary to common usage/plain meaning
         a. The words used may have had an unintended implication
   D. If none of the above then look to Legislative history to see if:
      1. Judicial interpretation: Congress may be using a term of art which had been adopted by the courts
      2. Deliberate ambiguity: maybe Congress left it to courts to interpret the term in accordance with standards at the time
      3. Unintended ambiguity: Congress just may not have been thinking and accidentally left the term vague.
   E. Statutory meaning of arithmetic operations
      1. Excess of X over Y = X minus Y
      2. Sum of which = add
      3. Bears the same ratio as = divide
II. Tax Policies – various justifications for different tax rules in the IRC
   A. Revenue Generation
      1. Revenue effects: How much gain or loss in tax receipts does the provision cause.
      2. Administrative convenience: Does the provision permit uniform, low-cost enforcement
         a. Application
            i. §63 standard deduction to discourage every TP from itemizing for nickel and dime itemizations which would require a lot more effort for auditors
      3. Taxpayer compliance: Is it feasible for TPs to have the resources available to comply with the provision/ will TP's understand why the provision is in place.
         a. Application
            i. §1 progressive rate structure: lower tax burden on those with less resources available to pay the tax
   B. Distributive Justice
      1. Transactional equity: If the provision is new, does it contain safeguards to protect reliance interest and prevent windfall gains and losses

2. Vertical Equity: Does the provision allocate tax burdens differently for individuals with differing circumstances
    a. Application
        i. §1 progressive rate structure: proportion of income you pay in taxes increases as your income increases
3. Horizontal Equity: Does the provision allocate similar tax burdens on those in substantially similar circumstances
    a. Application
        i. Old Colony Trust: We tax amount paid by 3d pty to discharge the obligation of the TP b/c that is the same as if 3d pty had paid TP directly and we want to tax both transactions the same (substance over form)

C. Economic Progress
1. Economic Neutrality: Does the provision not create incentives to change behavior in order to reduce tax burden
    a. Application
        i. **§162** business expenses deduction: if didn't allow deduction, ppl. would be discouraged from starting businesses
        ii. But sometimes intentionally violate economic neutrality to encourage behavior congress things is good (e.g., charitable contributions deduction, annuity and life ins. savings)
2. Economic Growth: Does the provision promote or retard economic growth?
3. Economic Stability: Does the provision ameliorate or exacerbate fluxuations in the business cycle

D. Policies specific to taxation of property
1. Liquidity concerns: Will imposing at tax on the property force the TP to sell the property in order to have the cash to pay the tax
2. Capital lock-in effect: Will imposing at tax on the sale of property so greatly reduce net proceeds on sale that discourages TP from selling to purchase a better investment.

<u>**Scope of the IRC**</u>:

I. Individual tax liability

A. **§1(c)** "There is hereby imposed on the taxable income of…every individual…a tax…"
1. "hereby imposed" creates the legal liability to pay tax
2. "every individual"
    a. Not defined, so interpret with common usage to mean every living, breathing human being (even babies)
        i. **§6012(b)(2)**: filing of taxes for incompetents (provides further support that congress did intent to impose liability on EVERY human being)

B. Limits of individual liability
1. "Of" connotes the individual must have ownership interest in the taxable income (common usage)
    a. This is important b/c the progressive rate schedule of **§1** encourages spreading taxable income among lower bracket family members

b. How to determine ownership interest:
    i. Assignment of Income Doctrine – judicially developed guidelines for determining income tax ownership to limit the improper shifting of income to reduce tax liability (see section of outline)
        a. Pretty much looks at beneficial ownership and control (common usage meaning of ownership)
        b. Legal title is not the standard b/c legal title is defined by state common law and this is a fed. income tax.
    ii. **§1(g)** "Kiddie Tax": Certain income of minors taxed "as if" it is the parents income
        a. Children to whom it applies:
            i. Child under 18; at least one parent alive at end of taxable year, child doesn't file joint tax return (isn't married)
        b. What amount of child's income taxed at parent's rate?
            i. Use child's normal tax rate unless:
            ii. The tax imposed by child's tax rate – net unearned income (basically gross income – income from labor) + allocable parental tax (parent's tax rate applied to child's net unearned income) is greater.
        c. Outcome: Kiddie tax closes any loopholes in Assignment of Income Doctrine by taxing child's income at parent's rate where if its likely parents where shifting money.

2. "every individual" doesn't include corporations, but **§11** imposes tax liability on corporations
3. Jurisdictional limits
    a. **§1** ("every individual") posses no limits on where individuals resides, and **§61** ("income from whatever source derived") posses no limits on where the income made, whether in US or another country.
    b. But **§2(d)** states that **§§ 1, 55** (progressive tax rates) shall apply to nonresident aliens but only as modified by **§§ 871 or 877**
        i. This confirms that we don't care about citizenship (noncitizens subject to tax too) b/c must be both an alien AND a nonresident for **§2** to apply
        ii. Taxation for noresident aliens
            a. **§871(a)(1)**: flat tax rate (no deductions) of 30% on gross income that is:
                i. received from sources w/in the US
                    a. this can include comp. incorporated in another country if it earns 25% of its income from US economy
                ii. is investment income (e.g., dividends, annuities, etc.)
                iii. not "effectively connected w/ conduct of trade or business in US" (i.e., the income is from passive investments)
                    a. But it would be hard to collect from NRA so we require the company issuing the funds to the TP to withhold
            b. **§871(b)**: **§§1, 55** apply as normal to income that is "effectively connected w/ conduct of trade or business in US

i. This means that NRA still taxed like everybody else on income that is received by being physically present and performing a personal service in the US.

c. **§877:** NRA who have been citizens w/in last 10 yrs. owe tax same as **§1** less the amount of tax paid to foreign governments, but only if such amount is greater than the tax imposed by **§871**

i. rat: prevent ppl. who inherit lots of money from denouncing citizenship and moving to avoid US income tax

C. Rationale: Most fair way is to require every person to contribute to burden of supporting society

1. But limits based on:
   a. Ability to pay (progressive tax rate)
   b. Income comes for either citizenship, residence, or source w/in US
2. Problems:
   a. Unfair to tax based soley on citizenship b/c not getting the same benefits as residents.
      i. Most countries only tax on residence and source, not citizenship
   b. If all countries taxed like US (tax US citizens living in their country or their citizens living in US) then a lot of ppl. subject to double taxation and cause economic collapse
      i. solve by giving foreign tax credits, foreign labor exclusions, and international treaties

D. What is the individual liability? Pay the tax rate specified in **§1** on all "taxable income"

1. Taxable income = gross income – deductions (**§63** def.)
2. Gross income = "all income from whatever source derived" (**§61** def.)

E. Tax Rates of **§1**

1. **§1** employs a progressive rate schedule – the higher tax rates only apply to income greater than the next lowest tax bracket
   a. Point – you can never be financially worse off by making more money
   b. Counter arg – higher tax rates may deter productivity. More work = more income = higher rate (less take home money), the work may not be worth the take home to the indiv.
2. Rationale:
   a. Vertical equity: Individuals who are in materially different circumstances should be treated differently
   b. TP compliance: If we impose same tax on very lowest income generators, then we won't get anything from them (can't squeeze blood out of a turnip)
      i. Want to allow ppl. to meet their basic needs first
      ii. Counter arg: could still impose flat tax but exempt lowest bracket
   c. Benefit based principle: Those with the highest income are getting the most benefit from the gov't (income as proxy for benefits received)
   d. Minimize sacrifice: Poor ppl. need the money to survive b/c money has decreasing marginal utility (the more you have, the less you need it)

i. Counter arg: decreasing marginal utility as constant for all individuals has not been shown

e. Economic neutrality: Tax law should interfere as little as possible with economic decision making (should not create incentives to alter behavior in order to reduce liability)

   i. Progressive rate schedule does violate economic neutrality b/c reduces take home money (ppl. might think take home money not worth the effort of working up to a certain point) but less of a violation than flat tax would be.

3. Other alternatives?
   a. Progressive: proportion of income you pay increases as your income increases (this is what we use)
      i. rate only applied to income within each bracket
   b. Proportional: flat rate
      i. rate applies to all income (this would really discourage productivity)
   c. Regressive: proportion of income you pay decreases as you income increases
      i. rate still only applies to income w/in each bracket but rates of each bracket decrease as income increases
   d. Head tax: each person pays the exact same amount
      i. this is the only option that doesn't violate economic neutrality but violates all the other justifications for progressive rate.
4. Note – rate schedules of **§1** are changed each year by the Secretary (see **pg. 1869** for 2006 table)

II. Corporate Tax Liability
   A. **§11**: "A tax is hereby imposed…on the taxable income of every corporation"
      1. "every corporation"
         a. "Corporation includes association, joint-stock companies, and insurance companies (**§7701(a)(3)** def.)
            i. "Includes" used in a definition means that examples in the definition are not exclusive but just examples (**§7701(c)** def.)
            ii. Point – corporation = for profit businesses (common usage) and some not for profit business
      2. Are cities included in the definition of corporation?
         a. **§115**: "gross income does not include income…accruing to any State or political subdivision thereof"
            i. B/c **§1** and **§11** are the only two provisions that impose an income tax, **§115** exclusion wouldn't be necessary unless **a city could be considered a corporation in some circumstances** (negative implication)
         b. Limits to **§115** exclusion: The income must be derived for any "public utility" or the exercise of any "essential government function"
            i. Def. of public utility – common usage
            ii. Def. of essential gov't function – common usage
               a. could mean something that is absolutely necessary or could just mean sound business practices – have to argue congress. intent

c. Application:
   i. interest from city putting money in a bank is probably excluded under **§115** b/c it is probably derived from an "essential gov't function"
      a. helpful to the gov't
   ii. but if city takes over the bank, then interest derived therefrom is probably not excluded under **§115** b/c running a bank is not an "essential gov't function" and the city starts to look more like the examples of corporations under **§7701(a)(3)**.

B. What is the corporate tax liability?
   1. **§11(b)** progressive rate schedule for corporations
      a. But the lower tax brackets are very narrow, so for all practical purposes this is like a flat tax.

III. Basic Tax Computation

A. Generally
   1. **§1** imposes the tax liability on "every individual['s]" "taxable income
   2. Rest of the IRC tells us how to calculate "taxable income"

B. The Equation

Gross receipts (all items of value received)
- Loan proceeds (return of capital)
- Cost of goods sold (adjusted basis **§§1011-12**)

Gross Income (**§61**)
- Exclusions (**§§101-39**) .

Gross Income ("as otherwise provided" **§61**)
- Nonitemized deductions (business expenses, losses for sale/exchange of property, alimony payments **§62(a)**) .

Adjusted gross income (net income **§62(a)**)
- Itemized deductions OR the Standard deduction (**§63**) (consumption related expenses for behavior congress wants to incentivize: mortgage interest, medical expenses, charitable contributions, property tax, etc)
- Personal exemptions (**§151**) (but personal living expenses never excluded **§262**)

Taxable income (the tax base **§63**)
X Progressive rate schedule (**§1**) .

Tax imposed (**§§1, 3**)
- Credits (**§§21-52**) .

Tax due

C. Items that reduce the tax base
   1. Deductions
      a. Value is proportional to your tax bracket ($1 deduction from the 35% bracket will save 35cents, but $1 deduction from 10% bracket will only save 10 cents)
         i. Point – deductions are worth more to the wealthy
      b. Function
         i. If tax burden apportioned on ability to pay, need to account for expenses that reduce TP's ability to pay (cause reduction in resources available for consumption or savings)

ii. Economic neutrality: If didn't allow business expenses deduction, it would discourage ppl. from starting their own business.
iii. Social engineering: Allow deduction for expenditures on behavior that Congress deems "good" (mortgage interest, charitable contributions, etc.)

c. Itemized v. nonitemized
   i. Value: Itemized deductions only reduce the tax base if all itemized deductions together are greater than the standard deduction.
      a. Point – TPs would prefer congress classify a deduction as non-itemized but that is the only kind that reduces tax base for all TPs
   ii. Function:
      a. Nonitemized deductions relate to cost of producing income
         i. Everybody can take advantage
      b. Itemized deductions relate to limited consumption activities that congress wants to incentivize.
         i. Typically only homeowners qualify
      c. Standard deduction discourages nickel and dime itemizing for administrative convenience except for those that really should be itemizing

2. Exclusions
   a. Value same as a nonitemized deduction
      i. Value depends on TP's tax bracket (worth more in higher brackets)
      ii. Available to all TP's (unlike itemized, which are only chosen by those whose aggregate itemizations exceed the standard deduction
   b. Function: Exemptions are items of value coming in, which historically congress has chosen to ignore, whereas deductions are expenditures
   c. Ex. **§103(a)** interest earned from state/local bonds
3. Credits
   a. Value is the same regardless of your tax bracket ($1 credit saves $1 whether in 35% tax bracket or $10 tax bracket)
   b. But if tax bracket rate is greater than credit rate, TP prefer deduction over credit
      i. ex. If charitable contributions were a 25% credit instead of a deduction, a TP w/ $100 GI and contributes $100
         a. in 35% tax bracket would still be at a negative $10
         b. in 10% tax bracket would get a a$15 refund
      ii. Point- the wealthy prefer deductions over credits
   c. This means that when congress chooses to grant a deduction instead of a credit for certain consumption activities (e.g., charitable contributions) they are providing a greater incentive for the rich to consume that particular product.

<u>**Scope of Gross Income**</u>

I. **Statutory Scheme**: **§61** "gross income means **all income from whatever source derived**, including…compensation for services, fees, commissions, fringe benefits, and similar items"

A. Income = increase in resources available for consumption or savings = accession in wealth/enrichment
B. Gross income includes
    1. Types specified in **§61(a)(1) – (15)**
    2. Indirect benefits
        a. Payment by a 3d pty to discharge an obligation the TP would otherwise have to pay (**Old Colony** – ER's payment to IRS of EE's tax liability is included in EE's gross income)
            i. Rationale
                a. b/c that is equivalent to the TP directly receiving the payment (enrichment)
                    i. **SUBSTANCE OVER FORM –** economically equivalent transactions must be taxed the same.
                b. Economic neutrality: IRC shouldn't create an incentive to change how ppl. work
                c. Horizontal equity: TP who has taxes paid by employer is in same position as someone who had the employer pay them that amount directly, both should be taxed the same.
                d. Payment by employer can't be a gift (which is an exclusion) b/c consideration, not gifts, come out of an employment relationship
                e. NOTE – ct. ignored plain meaning of income (direct benefit to TP) b/c that would be contrary to policy and yield absurd result
        b. Benefits provided by the gov't: we "pay" for these benefits when we pay our tax and **§275(a)** expressly forbids a deduction for tax payment
            i. But **§164(a)(3)** does allow a deduction for state/local taxes even though those are paying for a benefit too.
            ii. Rationale:
                a. Horizontal equity: depending on what city you live, TPs may not get the same benefit for the local taxes paid, but with fed. taxes all TPs entitled to the same benefits for the same price
                b. Taxpayer perception: if allowed deduction for income tax paid, gov't would have to tax at a much higher rate just to get the same amount after the deduction (have to tax at 100% just to get 50% rate after deduction – looks bad to TPs)
    3. **§61** makes no distinction b/t cash income and other kinds of non-cash receipts (see following sections for specific rules)

II. In-Kind Income (non-cash benefits)

A. Gen'l inquiry: trying to measure extent of TP's enrichment (actual value of the in-kind income to this TP)
B. Transferable Goods/Services
    1. Method of Valuation: Net amount (sales price – cost of sale) the TP could have obtained on the sale of the goods/service (FMV)
        a. Exception: If TP gets a objective benefit greater than FMV, use that measure (**Haverly** – TP didn't claim free books received then took $400 deduction when donated the books. Ct. held even though FMV of books

was less then $400, that was the income b/c that was the objective benefit received)

2. Justification
   a. Provides an objective measure of minimum enrichment b/c TP could have at least gotten FMV rather than using the service
   b. FMV, rather than retail price, better est. what this TP could have received
3. Problem: This method only measures enrichment if TP does transfer, if TP doesn't transfer then TP values the enrichment more than the mkt
   a. we just accept this fault b/c we want an objective standard

C. Non-transferable goods/services
   1. Method of Valuation:
      a. If TP doesn't use the service → value is $0 b/c TP didn't receive a benefit/wasn't enriched
      b. If TP does use the service → several valuation options
         i. Expenses avoided (probably the gen'l rule): What TP has paid for the similar service in the past
            a. Justification
               i. Objective and subjective valuation: not only measure objectively expenses saved, but the value TP places on the enjoyment derived when paid the benefit in the past.
               ii. Horizontal Equity:
                  a. TP not in same position as someone who makes similar salary but had to pay for the benefit received, so should be taxed something for the benefit (**Dissent in Benaglia**)
                  b. TP didn't get the same enjoyment from the benefit as somebody who voluntarily paid for the service, so shouldn't be taxed as high (**Turner** case: TP won non-transferable trip on the radio, court split difference b/t IRS advocated retail price and TP advocated price)
         ii. Rejected alternatives
            a. Retail value of benefit – no good b/c forced consumption
            b. EE's subjective valuation – can't fairly and consistently apply
            c. Cost to person providing the benefit – wrong inquiry, determining enrichment of TP not correlated w/ cost to provider
            d. Zero – no good b/c TP is certainly being enriched to some extent

D. Exclusions for certain ER provided benefits
   1. **§119(a)** Meals and Lodging: ER provided M&L not included in gross income if provided for the convenience of ER and
      a. **(1)**Meals: meals furnished on business premises of ER
      b. **(2)**Lodging: ER required to accepted lodging on business premises of ER as condition of employment
      c. Justification
         i. Convenience of ER doctrine (**Benaglia**: M&L provided to hotel manager were not gross income)
            a. Forced consumption/Horizontal equity – B/c EE did not voluntarily choose to get the benefit of free M& L, should not be

taxed the same as someone who does b/c can't be sure both got the same enjoyment from the M& L (the 2 transactions are not in substance the same)

    b. Business necessity – benefit only being provided b/c it's a matter of business necessity for EE to be onsite at all times (shouldn't tax EE for service provided solely for ER's benefit)

  d. Interpretation of "convenience of employer" doctrine
    i. NOTE **Treas. Reg. §1.119-1** interpretation
      a. "Convenience of ER" = "substantial non-compensatory purpose" rather than "business necessity" as used in Benaglia or else **§119(a)(2)** requirement of condition of employment would be duplicative.
      b. "Business premises of ER" = place of employment of EE
      c. "Condition of employment" = business necessity
        i. NOTE – this condition only applies in the lodging context
        ii. Factors to arg. business necessity
          a. EE has 24 hr. minute by minute duties (like mngr. of ritzy hotel w/ high maintenance guest in **Benaglia**)
          b. Something about official residence necessary for job functions (like prez. of university hyp)
          c. Point – could EE realistically carry out job functions if not onsite accessible 24hrs. (probably not for corp CEO
    ii. Convenience of ER = "business necessity" (**Kowalski** - Congress intended to adopt term of art used in Benaglia)
      a. This is implicity saying that must be a biz. necessity for both meals and lodging, rather that Treas. Reg. §1.119-1 interp. of biz. necessity only for lodging
    iii. **§119(b)(2), (3)** – whether EEs are compensated extra for the meals then charged for the meals, or meals themselves provided is the same thing (substance over form) and all excluded from GI (**Sibla** – amount ER paying EE higher salary, then charging for meals provided by ER is excluded from GI)
      a. Substance over form (paying EE more, then charging for meals in substance is same thing as providing meals for free)
      b. This cuts against **Kowalski**, which held that cash payments for meals not excluded under plain lang. of **§119(a)**.

2. **§107** Rental value of home provided to ministers of gospel
  a. Like **§119** (enacted b/f §119) but no convenience of ER test
  b. Limits
    i. **(1)** Can only provide a "home"
      a. Likely if provide large farm, then can't exclude cost of land, animals, other things more like a business than a home (but normal sized yard, garage, etc. are part of a "home"
    ii. **(2)** – rental allowance provided can't exceed FMV
    iii. Likely an implicit time provision – can't use rental allowance to pay off mortgage on home, then leave church w/ free house

    iv. "Compensation" provided via rental allowance shouldn't exceed the work the minister is doing (arg. against TP setting up his own church then donated all his income, then paying himself via a rental allowance)
3. **§132** Fringe Benefits:
    a. **§132(a):** 8 enumerated fringe benefits excluded from GI
        i. **(1)** No additional cost service – limited to services provided only of the type ER is in industry of providing
        ii. **(2)** qualified EE discount – includes property or service but must be of the type ER is in industry of providing
            a. discount only deductible to the extent it doesn't exceed ER's gross profit percentage (can't be offered to EE at less than what ER paid for the product)
        iii. Note – **§(j)(1)**"highly compensated employees" can only exclude no cost services and EE discounts if the same deal is made to all EE's
            a. graduated discounts based on tenure don't get around this rule b/c substance over form – have to be an equal percentage of highly compensated EEs and non highly compensated EEs to meet the standard
            b. **§414(q)** "highly compensated EEs = 5% owner of make more than $80K
            c. Justification
                i. Poor TP morale if allow only highly paid EEs to take advantage of the exclusion
                ii. Incentivize broad distribution of tax benefits
                iii. Highly paid EEs are likely the ones who make the decision to offer EE discounts, don't want to allow them to abuse system
        iv. **(3)** working condition fringe – if it would be deductible under **§162** business expense deduction, then excludable here
            a. **§162** business expense deduction – can deduct all the ordinary and necessary expenses of conducing a business
                i. All EE's are considered to be in the same biz as ER
                ii. "ordinary and necessary" interpreted to only mean anything that is helpful to carrying on biz (ct. doesn't want to get into deciding business judgment of ER)
                    a. Note – hypo on attys getting cab rides/meals paid for by firm not excludable b/c not biz. expenses but ER paying for first class plane tickets and hotel are biz. expenses
            b. **Treas Reg. 1.132-5** Special rule for EE product testing
                i. Consumer testing/evaluation is a biz. exp. for ER
                ii. Biz. reasons necessitate the testing/evaluation be performed off premises by EE
                iii. Item furnished to EE for purpose of testing
                iv. Made available for no longer than to test and returned at completion of testing period

v. ER imposes limitations on EE's use that significantly decreases the value of personal benefit to EE (e.g., ER limits model EE can select, ER says EE's family can't use, etc.)
vi. EE must submit detailed report on the testing
    a. Class hypo – Ford can probably provide company car to exec. to "road test"

b. **(4)** de minimis fringe – value of fringe benefits is so small that accounting for them would be unreasonable or administratively impracticable
   i. **Treas. Reg. §1.132-6** – only look to value provided to indiv. employee, but not de minimis if benefit provided on a regular basis
c. **(5)** qualified transportation fringe – transportation provided in a "commuter highway vehicle" with seating for 6, not including the driver, with at least 80% of miles driven for commuting, and ½ of the passengers are commuters
d. **(6)** qualified moving expense reimbursement
e. **(7)** qualified retirement planning services

4. **§132(h)** – retired/disabled EEs and spouse/dependant children of EE's are treated as EEs
5. Method of valuation if not excludable: FMV of benefit – any cost paid by EE
   a. Note – this test will only work if the benefit was transferable.

III. Imputed Income

A. Rule: Settled non-statutory rule that Congress chooses not to tax imputed income, even though TP is receiving a benefit/being enriched
   1. Def. of imputed income: benefit derived from the use of "household durables" (e.g., house, car, tv that you own) and performance of personal services for your own or family's benefit
   2. Examples
      a. Owner occupied home: TP 1 who rents out house has to pay tax on rental income, then use after tax income to pay for own housing. TP 2 lives in house rather than rents, does not have to pay tax on the value of living in own house.
      b. Performance of personal services: TP 1 who works outside the home and hires a nanny has to pay the nanny with aftertax dollars. TP 2 stays at home and doesn't have to pay tax on benefit of having kids looked after.
         i. Includes entertainment services such as entertaining yourself by playing a game

B. Rationale
   1. Valuation problems: hard to determine what owner could have rented home for if had chosen to rent (which is the only obj. measure of the imputed income from owner occupied housing) or would have paid for personal service if had chosen not to do it herself.
   2. Social engineering: intention violation of economic neutrality b/c social benefits to owning home and living in it (more likely to take an interest in the community if have something at stake)

        a. This rationale doesn't apply to personal services so congress created **§21**: credit for expense of household/child care services necessary for gainful employment

C. Problems
    1. **Old Colony**: In substance TP receives indirect benefit from living in own house same as TP who receives benefit from renting out house.
    2. Horizontal equity violation: Owner occupied housing/ performing own personal services for the family is given preferential treatment over owner who rents/hires somebody to perform the service, even though both receiving benefit from the ownership of home/performance of a service.
    3. Economic neutrality violation:
        a. Huge incentive to own home and live in it, rather than rent.
        b. Huge incentive perform own personal services, even where services more valuable elsewhere.

D. Alternative solutions
    1. Tax neither the imputed income, nor the money spent on the consumption alternative to imputed income.
        a. Problems
            i. Contrary to **§262** – no deduction for consumption expenses
            ii. Economic neutrality violation – incentive to spend more money on housing/personal services b/c its all deductible
    2. Tax imputed income (tax both)
        a. Problems:
            i. Most voters are home owners, want to keep them happy
            ii. Valuation problem of imputed income (even harder to value personal services than rent)

E. Limits:
    1. If don't perform the personal service for yourself → not imputed income
        a. ex. – neighbor moving your yard in exchange for you mowing his yard is not imputed income
        b. Rationale – if not doing a service for yourself, then must have seen a greater value in having someone else do it for you.
        c. Valuation – **Treas. Reg. §1.61-1(d)(1)**
            i. Services paid for in property: FMV of property taken in payment
            ii. Services paid for in exchange for other services: FMV of services take in payment
        d. Exceptions
            i. Congress has chosen not to tax carpool exchange services
            ii. If receive entertainment by friend playing a game with you, don't tax b/c too much like imputed income
    2. Hobby income (incidental enrichment from entertainment/recreation services)
        a. Rule: Taxable under **§61** b/c enrichment and §61 does not differentiate b/t sources of the income
        b. Deductibility?
            i. **§262** gen'l rule that household/living (consumption) expenses are never deductible v. **§ 162** business expense deduction rule

ii. **§ 183** compromise: deduction for hobby expenses that produce income, but no more than the amount of income the hobby produces

IV. Compensatory Receipts (compensation by a 3d pty for a loss caused by that pty)

A. Clark Rule: not taxable on compensation from a 3d pty for a loss that was caused by that pty (**Clark** – TP not liable on amount atty paid to IRS to satisfy tax obligation caused by mistake of the atty)

1. Rat – TP is not enriched by the loss compensation b/c would not have had the loss but for the 3d pty
2. Problem – Clark only extends to losses caused by a 3d pty, but not losses caused by the TP herself
    a. Horizontal equity violation: Whether TP causes the loss herself or a 3d pty causes the loss, both TPs are in same position so should be treated the same.

B. **Raytheon Replacement Rule**: Must ask "in lieu of what were the damages award"? If the damages in lieu of something that would be TI, then the damages are TI.

1. Rat – Substance over Form! (Old Colony – must collapse the 2 step transaction into 1)
2. Test – factual inquiry into what controversy all about to determine what damages "in lieu of"
3. Specific application of compensatory receipts test
    a. Total destruction of property/Goodwill(favorable biz/product reputation): taxable if compensation exceeds costs of the property/goodwill (this was **Raytheon** holding)
        i. Treat just like a voluntary sale (only taxable on gain)
        ii. All return of capital is tax free
        iii. Note – burden of proving costs is on the TP (**Raytheon** had to pay tax on all their recovery b/c didn't prove costs of its goodwill)
    b. Partial destruction of property/Goodwill: several taxation options that congress uses in various circumstances
        i. ROC Pro Rata: Divide cost of property up by percentage of property damaged and tax damages less pro rata cost.
            a. ex. Property cost \$5K, 60% destroyed, and \$30K recovery. ROC is \$3K and tax is \$27K (\$5K X .6 = \$3K (ROC))
        ii. ROC Last: Tax all recovery now and give offsetting ROC tax break when TP sells the property
            a. ex. Property cost \$5K, 60% destroyed, and \$30K recovery. ROC offset is \$5K when TP sells and tax on all \$30K now
            b. IRS prefers this option b/c gives them money now, which is worth more than money later
        iii. ROC First: Allow ROC for the cost of the entire property to offset the recovery now and when TP sells property will get now ROC offset
            a. ex. Property cost \$5K, 60% destroyed, and \$30K recovery. ROC offset is \$5K off \$30K in damages now and no ROC offset when TP sells.

        b. TP prefers this because gives them money now, which is worth more than money later
      iv. **§1033** Involuntary Conversions: Not tax TP on amount of recovery used to repair or replace the damaged property
        a. The increase of value caused by the repair will be reflected in later sales proceeds, which are taxable.
    c. Malpractice – **not taxable** b/c it is simply replacing money TP never should have had to expend (**Clark Rule**)
    d. Medical/Out of pocket Expenses – **not taxable** b/c replacing money that has already been taxed
    e. Pain and Suffering – **not taxable** b/c replacing your healthy mental state which is tax free imputed income
    f. Lost Wages – taxable b/c replace ordinary income which is taxable
      i. This includes damages for breach of contract
    g. Lost earning capacity (future wages) – same thing as lost wages, but just in the future
    h. Punitive damages – this is not replacing anything to TP, but punishing the wrongdoer so Raytheon "in lieu of" test doesn't apply
      i. **Glenshaw Glass Rule**: A windfall is always GI and taxable without an explicit statutory exception
        a. Rat – Congress intended §61 to reach as far as their constitutional power to tax extends
        b. Note – S. Ct.'s last attempt to define "income" – "undeniable accession of wealth, clearly realized, over which TP has complete dominion"
          i. Accession in wealth – synonym for increase in resources available for consumption or savings
          ii. Clearly realized – increase in value of property is only taxable once it converts to another form (e.g., sale)
          iii. Complete dominion – have absolute control over resources
            a. unclear whether ct. actually enforces this 3d prong b/c dominion is not really a defining characteristic of income

C. **§104(a)** Exclusion for compensation for personal injuries
  1. **§104(a)(2)** "GI does not include damages (other than punitive) received on account of physical injuries or sickness"
    a. Basically all compensation for personal injuries, other than punitive damages, is tax free
  2. How this rule changes results under Clark/Raytheon/Glenshaw
    a. Damages which maintain the same tax status
      i. Damages that aren't for personal injury (e.g., destruction of property, malpractice) - same as Raytheon b/c not a physical injury/sickness so §104 doesn't apply
      ii. Damages for med. exp.– same as Raytheon, and final 2 sentences of §104(a) allow exemption for medical expenses even if caused by emotion distress rather than physical injury

iii. Punitive damages – same as Glenshaw Glass b/c §104 specifically says it doesn't apply to punitive damages
b. Damages that §104(a) changes the tax status
i. Damages for pain and suffering – same as Raytheon but only if can prove "on account of" physical injury
a. Final 2 sentences of §104(a) clarify that pain and suffering from emotion distress is not excluded, which is **diff. from Raytheon**
ii. Damages for lost/future wages – **diff from Raytheon**, exempt if can prove "on account of" personal injury/sickness
a. Under Raytheon, these are never excluded.
3. Justification
a. Administrative convenience – response to administrative nightmare have having to determine what portion of lump settlements paid for what type of damages, which was necessary under Raytheon b/c lost wages taxable but pain/suffering/medical expenses not taxable.
i. Not as much concern w/ separating punitive damages out of settlement b/c punitive damages usually allocated separately or comprise 2/3 of the settlement (treble damages).
b. Vertical equity – injustice to bump up TP's tax bracket the year settlement received, when if no injury had occurred the same income would have been spread over several years.
c. TP compliance – voters would be really upset if suffer a serious injury, then IRS takes 35% of the settlement in taxes.
D. Rule as it currently stands
1. If damages from a personal injury always apply **§104(a)** rules
2. If damages from something other than personal injury:
a. Debate
i. **§104(a)** can be read as an inclusion rule so that if damages aren't excluded in **§104(a)**, the congress meant to tax them.
a. This would make **§104(a)** unconstitutional b/c GI can not encompass damage to reputation, ect b/c its imputed income (**Murphy** recent case from D.C. Cir.)
ii. **§104(a)** can be read to only apply as a narrow exclusion, and apply **§61** as interpreted by Raytheon in all other cases.
a. Raytheon allows exclusion of emotional/reputational damages.
E. Compensation for previously deducted losses (negative profit)
1. Previously deducted net operating loss (NOL)
a. **Sanford and Brooks Rule**: If recovery of damages is to compensate for losses in previous tax year → loss is taxable.
i. Justification
a. **§441(a)** – taxable income is computed on the basis of TP's taxable in come for that taxable year alone.
b. Administrative convenience – Congress needs to be able to make the income tax operational, a good way to do that is look at each tax year with blinders on, even if causes unfair results in some cases.

            c. Prudential concerns – if hold that income under the constit. is overall enrichment, then every tax case would become a con law case for S. Ct. consideration
        ii. Problem – Unfair to tax on a break even transaction w/out any net gain or enrichment - even if TP deducted the loss in a pervious year, may not have had any income in that year to offset the loss, so when receives recovery for losses in subsequent year TP is just breaking even.
    b. **§ 172** Net operating Loss – Congressional response to unfairness in Sanford & Brooks rule
        i. **§172(a)** net operating losses from other taxable years may be carried over or carried back as a deduction
            a. **(b)(1)** Carry back for 2 prior yrs or carry over for 20 succeeding yrs.
                i. Must offset by first in time (if NOL in '06, must first offset gains from '05, then '04, then '07 and carry forward from there)
                ii. Rat. for carry back – b/c usually NOL occur in recessions and carry backs allow an immediate refund/relief upon filing an amendment instead of having to wait for end of tax year to file your taxes for a carry forward deduction.
            b. **(c)** Net operating loss = excess of deductions over GI (negative profit)
                i. **(d)** Can't take personal exclusions into account when calculating NOL, only business deductions
2. All other previous deductions
    a. Tax Benefit Rule(s):
        i. Inclusionary Rule: If have a deduction in a prior tax year that offsets income, then later recover that deduction, must include the recovery in GI
            a. Rat – prior deduction was an error, so need to correct it b/c TP did receive net enrichment.
            b. ex. TP takes deduction for stolen money, then recovers the money the next year.
        ii. **§111(a)** Exclusionary rule: If have a deduction in a prior tax year but it doesn't offset any income, then later recover that deduction, the recovery is excluded from GI
            a. Rat:
                i. prior deduction was harmless error and although TP recovered she reaped no net enrichment.
                ii. filing an amendment isn't correct b/c the error did not occur in the year the deduction was made.
            b. ex. TP takes deduction for losses on sale of stock, then recovers for securities fraud in the inducement to purchase the stock but recovery still doesn't make up for losses suffered (**Dobson** case)

iii. For TBR to apply, the recovery must be for the same thing as the deduction (thus TBR wouldn't apply to Sanford & Brooks b/c deductions were for business expenses and recovery was for breach of contract of misrepresenting nature of the job)

b. Note - **§165** allows a personal deduction for any loss sustained in a trade or any transaction entered into for profit (e.g., investments)

3. Note – the Rules of Sanford & Brooks and Dobson would both be the same under Raytheon Replacement Rule
   a. Sanford & Brooks: damages "in lieu of" cost that contract would have been had gov't been honest about nature of the job. Increase contract price is in lieu of wages → taxable recovery
   b. Dobson: damages "in lieu of" purchase price of stock, which TP overpaid due to fraud. Amount overpaid is in lieu of after tax dollars → tax free recovery.

F. Health care costs: - 4 options
   1. ER provided health insurance
      a. Inclusion
         i. A type of in-kind benefits → taxable under **§61** (makes no distinction b/t cash income in in-kind benefits)
      b. Exclusion/Deduction allowed
         i. Premiums: excluded under **§106(a)** – GI doesn't include ER provided coverage under an accident or health plan
         ii. Proceeds (reimbursement of costs): excluded under **§105**
            a. **(b)** but limited only to "medical care" costs (see def. below)
      c. Result – Congress provided by far the most incentives to purchase ER plans
   2. Individually purchased heath insurance
      a. Inclusion
         i. A type of savings → taxable under **§61, §263(a)** (no deduction for savings
      b. Exclusion/Deduction
         i. Premiums: limited deduction under **§213(a)** – 3 circumstances must be met
            a. Must be for "medical care" – def. in **§213(d)(1)** below
            b. Can deduct amount that exceeds 7.5% of AGI
            c. Must be an itemized deduction (only helpful if total itemized deductions exceed standard deduction)
         ii. Proceeds: excluded under **§104(a)(3)** – excludes proceeds received from health ins. coverage that was not ER provided
      c. Result – This is the worst option b/c premiums probably won't be great enough in 1 yr. to meet floor deductible amount
         i. **§441(a)** – must compute deductions based only on the taxable year
   3. Out of pocket payment of health care costs (self insurance)
      a. Inclusion
         i. A consumption expense → taxable under **§61, §262(a)** (no deduction for consumption expenses)

b. Deduction
    i. Premiums: no premiums when self insuring
    ii. Proceeds: limited deduction under **§213(a)** – 3 circumstances must be met (described above)
        a. Point – only deductible if expense was extraordinary
c. Result – This is the 2d best option b/c if get really sick then expenses in 1 yr. should be great enough to meet deductible floor amount
    i. Unlike premiums which are spread out, expenses are bunched in 1 yr.

4. Deduction for "self employed"
    a. Deduction
        i. Premiums: **§162(l)** – deduction for amount expended on "medical care"
            a. **§213(d)(1)** def. of "medical care" includes premiums
        ii. Proceeds: excluded under **§104(a)(3)** – excludes proceeds received from health ins. coverage that was not ER provided
    b. Result – This works out to same effect as ER provided health insurance
5. **§213(d)(1)** def. of "medical care"= amounts paid for:
    a. **(A)**diagnosis/treatment/prevention of disease, or affecting a function/structure of human body
    b. **(D)** insurance
    c. **(C)** "qualified long term care services"
        i. **§7702B(c)** def. – includes maintenance and personal care services prescribed by a dr. for the chronically ill.
            a. w/out this express exclusion this would be seen as consumption and not excludable or deductible
            b. recent addition for Congress to incentivize babyboom generation to get ins. b/f become chronically ill.
    d. doesn't include things like plastic surgery, non-prescription medication, and sick pay. But for those, one of the transaction still e
        i. Note – if ins. pays for these things, one end of the transaction will still be deductible/excludable.

Funding Method	Health Ins. for "medical costs"		Health Ins not for "medical costs"	
	Premiums	Proceeds	Premiums	Proceeds
ER-Provided Coverage	Excluded §106(a)	Excluded §105(b)	Excluded §106(a)	Included §105(a)
EE-Purchased Coverage	Ltd. Deduction §213(d)(1)(D)	Excluded §104(a)(3)	No deduction §213(d)(1)(D)	Excluded §104(a)(3)
EE Self-Insurance	N/A	Ltd Deduction §213(a)	N/A	No deduction §213(d)(1)
Self Employed Ins.	Deduction §162(1)	Excluded §104(a)(3)	No deduction (?)	?

6. Moral Hazard Problem w/ current system – allowing "non-taxable" health care under ER plans causes ppl. to not care about lifestyle choices or expense of treatment choices, both of which drive up health care costs
    a. Solutions?

i. Could cap **§106(a)** exclusions based on what society deems "reasonable" health care plan
    a. Congress has never accepted b/c difficult to take away tax benefit once been granted
ii. ER Cost shifting – ER's not paying all of the premiums(withholding from EE's paycheck) and purchasing plans w/ deductibles/co-pays brings EE's attention to cost of health care
    a. EE deductibles/co-pays are taxed same as self insurance (not deductible unless exceeds **§213(a)** floor)
        i. Congress response – Health care savings account
            a. **§223(a)** Amounts contributed by "eligible EEs" to health care savings account are deductible.
                i. **§62(a)(19)** reaffirms this by stating that deduction from calculation of "adjusted gross income"
            b. **§106(d)** ER contributions to "eligible EE "health care savings account are treated same as **§106(a)** (not included in GI)
            c. **§223(c)** def. of "eligible EE" = insured under high deductible (more than $1,000 yr.) health care plan.
            d. **§223(e), (f)** interest and dividends earned on the health care savings acct. is also tax free, just like the balance.
                i. but if don't use the money for "medical care" (def. above) then pay full tax
    b. EE portion of premiums are taxed same as as indiv. purchased plans (not deductible unless exceeds **§213(a)** floor)
        i. But ER withholding portion of salary for premium is just like ER paying all of premium and reducing salary (substance over form)
            a. Congress response – exemption for benefits under "Cafeteria plan"
                i. **§125** "Cafeteria plan" = written plan were EE can choose b/t cash or a fringe benefit (having premiums paid)
                ii. Point – EE portions of premiums are excluded (codifies substance over form)

7. Policy
    a. IRC has huge health care finance incentives imbedded within
    b. But b/c most are deductions, greates incentive is on upper and middle class (b/c value of deduction greater the more your income is)
        i. To get lower class involved need to give credits instead of deductions
        ii. Bush's proposal: Allow standard deduction for health care
            a. Lets indiv. choose what kind of ins. to buy rather than ER, and incentives indiv. to pay att'n to cost/benefit of the ins.
            b. Problems
                i. Indiv. may just pocket the standard deduction and not buy health ins.

        ii. ERs have greater collective bargaining power to reduce cost of ins. than individuals have
        iii. Healthy ppl. will be the ones who choose to opt out of ins, which will drive up cost of ins. b/c only participants will be the sick ones.

<u>**Timing Rules**</u>

I. The Gen'l Timing problem

A. When TP makes an investment, want to make sure only tax on gain from investment
   1. Return of the investment (ROC) is already taxed savings so don't want to tax again.
   2. The interest/gain on the investment is the only enrichment, therefore the only portion which is taxable.

B. But how to distinguish b/t ROC (tax free) and income (taxable) when repayment on investment doesn't occur all at once.

II. Annuities – making a loan to ins. company and they agree to pay it back in yearly installments w/ interest w/in a specified time. Some portion of each payment contains ROC and some portion contains interest.

A. **§72(a)** gen'l rule – amounts received under an annuity K are included in GI

B. But need to make sure only tax on interest and not ROC portion of annuity payments - 5 Options workable options to tax term certain returns on investments
   1. **ROC first** – all payments are tax free ROC until capital has been repaid, then all payments are taxable income
      a. Taxpayers favor this option b/c maximum tax deferral, unless tax rates expected to increase
      b. This was how taxed pre '34, but **hardly uses anymore**
   2. **ROC last** – all payments are taxable income until guaranteed interest amount on the K has been paid out, then payments are tax free ROC
      a. IRS favors this option b/c money now worth more than money later
         i. But impractical when annuity if for life b/c no way to determine how much interest TP is eligible to receive (unless base on life expectancy)
      b. IRS uses this for **sale of property**
   3. **Pro rata ROC** – divide TP's investment in the K by the total amount to be received under the K (based on TP's life expectancy if K for whole life). That number gives the "exclusion factor." The exclusion factor is applied to each annual payment to determine how much is ROC and how much is taxable interest.
      a. Ex. TP purchases K for $3,790 which guarantees 5 yr. repayment w/ 10% interests (i.e, $1K each yr. for 5 yrs. amounting to $5K total)
         i. Exclusion factor = 3,790 / (1,000 X 5 = 5,000) = .758
         ii. Tax free ROC of each payment = $1K X .758 = $758
      b. This is the option used for **annuities §72(b),** and **depreciation of property**
   4. **Back loaded ROC** – tax just like a **mortgage payment**, interest rate applied to remaining capital on each payment, therefore b/c remaining capital reduces

with each payment the greatest amount of interest is being paid on first payment and reduces gradually as capital reduces

a. Ex. TP purchases K for $3,790 which guarantees 5 yr. repayment w/ 10% interests (i.e, $1K each yr. for 5 yrs. amounting to $5K total)
   i. 1st payment of $1K = $379 interest(10% of $3,790 full principal) and $621 ROC
   ii. 2d payment of $1K = $317 interest (10% of $3,790 principal less $621 previous repayment of principal) and $683 ROC
   iii. 3d payment of $1K = $249 interest (10% of $3,170 principal less $683 previous repayment of principal) and $751 ROC
   iv. 4th payment of $1K = $174 interest (10% of $2,490 principal less $750 previous repayment of principal) and $826 ROC
   v. 5th payment of $1K = $91 interest (10% of $1,740 principal less $826 previous repayment of principal) and $909 ROC
b. Reality is that TP is lender and ins. co. is borrower – just like mortgage
c. This is almost as bad for TP as ROC last, but not quite as bad

5. **Front loaded ROC** – tax each payment just like a separate **endowment K** maturing, which is paying money today for certain lump payment in future with compound interest
   a. Ex. TP purchase K for $3,790 which guarantees 5 yr. repayment w/ 10% interest (i.e, $1K each yr. for 5 yrs. amounting to $5K total). This would be viewed just like 5 separate endowment K for $1K each
      i. 1st payment of $1K = 1 yr. endowment K for $1K discounted by 10% interest rate = $1K/1.1 = 909 premium (ROC)
      ii. 2d payment of $1K = 2 yr. endowment K for $1K discounted by 10% compound interest = $\$1K/(1.1)^2$ = $826 premium (ROC)
      iii. 3d payment of $1K = 3 yr. endowment K for $1K discounted by 10% compound interest = $\$1K/(1.1)^3$ = $751 premium (ROC)
      iv. 4th payment of $1K= 4 yr. endowment K for $1K discounted by 10% compound interest = $\$1K/(1.1)^4$ = $683 premium (ROC)
      v. 5th payment of $1K = 5 yr. endowment K for $1K discounted by 10% compound interest = $\$1K/(1.1)^5$ = $621 premium (ROC)
   b. Basically just the opposite of back-loaded ROC

C. Life annuities
   1. Composed of 2 elements
      a. Savings element just like term certain annuity
      b. Insurance element to protect against living past expected life (run out of money)
   2. Need to unscramble the 2 components to tax properly
      a. Savings element – **§72(c)(3)** b/c total no. of payments unknown, use “actuarial tables” (**Treas. Reg. §1.72-9 V**) to calculate remaining life expectancy
         i. Exclusion ratio calculated by multiplying annuity payments by life expectancy to calculate total value of annuity K.
      b. Insurance element - **§72** pro rata ROC method is calculated for TP to receive full tax free ROC by death

                i. TP will have gain if outlive life expectancy - **§72(b)(2)** all payments after life expectancy are taxable in full
                ii. TP will suffer a loss if die b/f life expectancy - **§72(b)(3)** unrecovered principal is allowed as a deduction on annuitants last taxable year.
                    a. This is necessary b/c the IRC doesn't have a gen'l deduction for income.
    D. Deferred payment annuities – payments received under an annuity that are not the actual annuity
        1. **§72(e)** – taxed as ROC last
            a. Prior to '82 rule was ROC first, so TPs where purchasing deferred annuities that they never intended to collect on (e.g., maturity when turn 95 yr. old) but taking tax free dividends out under the annuity
            b. ROC last prevents that abuse.
    E. Benefit of annuities over other interest savings – get tax deferral on interest from annuities
        1. W/ a bank account you have to pay tax on the interest every year, but with annuity tax on interest is deferred (time value of $)

III. Life Insurance K

    A. Gen'l
        1. 2 kinds of life ins. K
            a. Term ins. – Insurance for fixed amount of time. Policy holder pays premiums to ensure payment of death benefit upon death. If policy holder lives past ins. term then policy expires and all premiums lost.
            b. Whole life ins. – Like term insurance, but if policy holder lives past the term of the K, then policy "matures" and policy holder gets death benefit.
                i. Premiums typically much higher then term ins.
        2. Like life annuities, life ins. is composed of 2 elements
            a. True life ins.- present with both term and whole life ins.
            b. Some savings/investment – applies to whole life only
        3. Need to unbundled and determine tax consequences for each
    B. Tax treatment of life. ins. component
        1. Analysis under Raytheon ("in lieu of" what is life ins. purchased)
            a. 3 main purposes for life ins.
                i. Alternative method of support of wage earner dies
                    a. This is replacement for labor income
                        i. Premiums: Costs of producing income are tax deductible
                        ii. Proceeds: Labor income included in GI (**§61(a)**)
                ii. Life ins. if homemaker dies
                    a. This is replacement for imputed income
                        i. Premium: Costs of producing tax exempt income are nondeductible
                        ii. Proceeds: Imputed income is tax free
                iii. Life ins. where beneficiary is not dependant on the insured
                    a. This is to provide inheritance
                        i. Premiums: Costs of producing tax exempt income are nondeductible

            ii. Proceeds: Inheritance income is tax free (**§102(a)**)
2. B/c the 3 diff. purposes for purchasing life ins. lead to diff. tax consequences, need to settle on one
    a. Otherwise too great administrative difficulty in sorting out indiv. reason for purchasing life ins. and taxing differently.
    b. Taxing as wage replacement seems to make the most sense b/c most common reason for purchasing life ins. but…
3. **§101(a)(1)** gen'l rule for taxing life ins. K
    a. GI does not include proceeds received under life ins. K if paid b/c of death of insured.
        i. B/c proceeds are excluded, premiums are nondeductible (**§264(a)(1)**)
        ii. Why did congress explicitly choose not to tax as wage replacement?
            a. Old rule
            b. Easy to apply b/c no tax consequences on either side of transaction
    b. But if 3d pty. buys life ins. K so they receive proceeds when insured dies - **§101(a)(2)** – amount excluded under **§101(a)(1)** shall not exceed amount paid by the 3d pty plus subsequent premiums paid by the 3d pty.
        i. Point – 3d gets taxed on any amount over what they paid for the ins. K (just like would tax any other purchase of property)

C. Tax treatment of savings/investment component
1. Only comes into play w/ whole life ins. proceeds
    a. Rat. for diff. treatment
        i. B/c premium is so much larger then term ins., only a portion of premium is used to purchase the term ins. and the rest is going into a savings account
        ii. Each year less term ins. is needed b/c the growing balance of your savings account offsets the term ins., so increasing amount of premium is going toward savings account until entire death benefit is composed of savings acct. (that's when policy "matures")
        iii. "Surrender cash value" is the value of your savings account
2. Rules
    a. If proceeds paid out by b/c death of insured **§101(a)(1)** exclusion applies
        i. This is so even if payment occurs near maturity, which means most of the proceeds are coming from the savings
        ii. Granting tax free interest on the savings account is huge tax preference to insurance industry and **violates economic neutrality**
            a. Gives those indiv. that save via whole life ins. favorable tax treatment over those that use savings account
        iii. **§101(g)(1)** Following amounts are to be treated as paid by reason of death of insured (excluded under **§101(a)(1)** even though insured surrendered policy for cash value)
            a. Insured is terminally or chronically ill (must be certified by dr.)
    b. If proceeds paid at maturity or for "surrender" cash value:
        i. **§72(e)(5)(A)** – proceeds shall be included in GI but only to the extend they don't exceed investment in K

a. Point – GI includes proceeds at maturity/surrender less aggregate of premiums paid

ii. Still a **violation of economic neutrality** b/c grants exclusion for portion of premiums that went to the term ins. and interest from the savings acct.

a. What we should do is tax the proceeds less amount that went towards savings b/c that would still leave the interest earned as taxable and not grant a deduction for the portion of the proceeds that went to purchase the term ins.

3. Benefits of whole life ins. v. interest savings

a. If pay b/c death of insured - tax forgiveness on interest from savings portion

b. If pay b/c policy matures/surrender – tax deferral and partial tax forgiveness on interest from savings portion; exemption for portion of premiums that went to purchase term ins.

c. Point – Huge incentive to buy life ins.

IV. Realization and Recognition

A. Realization of Income Generally

1. Congress only has constitutional authority to tax gains upon realization of those gains (**Eisner v. Macomber**)

a. Court goes back on this is **Cottage Savings** and says realization requirement was est. by Congress only as a matter of administrative convenience (see policy rationale below).

i. Court basically saying that they don't want all these tax cases in court and congress can chose whether and when to tax gains/deduct losses

2. Stock Dividends

a. **Eisner** holding - Stock dividends are not taxable (even though at time statute said were taxable) b/c they are just a piece of paper that works no substance in relationship b/t corporation and shareholder.

b. Rationale:

i. **2)** Income "derived" = TP must at least be given the option to withdraw the gain from the capital investment.

a. In corp. SH has no right to withdraw or partition (like with Partnerships) only transfer ownership, thus nothing "derived" from stock dividends unless SH given the option to receive cash dividend.

b. This is why we are taxed on interest from bank accounts even if don't withdraw → b/c have right to withdraw.

ii. No diff. b/t stock dividends and corp. just keeping dividends and reinvesting in corp.

a. Substance over form – stock dividend are just pieces of paper that represent SH same proportional interests in the corp. (nothing conferred).

iii. **Eisner** Dissent – Congress has auth. to define incomes, so long as its reasonable.

            a. Congress could tax corp. keeping dividends and reinvesting them if it wanted to, it just chose not to.
        iv. NOTE – This is all just a question of timing. TP will be taxed when sells stock b/c clearly separation of gain/loss from investment when sell. Question is always was the event a "realization," i.e, separation from investment event.
        v. Implications to corp – double taxation
            a. **§11(a)** treats corp. as indiv. so they are taxed on profits they make
            b. SH also taxed on those same profits when they are distributed
            c. But partnerships get pass through – only tax on profits when earned, not on distribution (**§§ 701, 702, 731(a)(1)**).
    c. Current statutory framework for realization (codifies **Macomber)**
        i. **§61(a)(3)** "gains derived from"
        ii. **§1001(a)** "sale or other disposition"
        iii. Stock dividends expressly excluded (**§305(a)**)
            a. But optional stock dividends are income **(§305(b)(1)**)
3. Policy
    a. Arguments for realization rule
        i. Volatility – if taxed on unrealized gains, then would have to allow deduction for unrealized losses, which would result in huge loss of tax revenue in recession years
        ii. Liquidity constraints – TP might have to sell the property to have cash to pay for the tax on gain
        iii. Administrative convenience – IRS would have to find way to value increase/decrease in property based on something other than sale price
    b. Arguments against realization rule
        i. Horizontal equity – 2 SH who own stocks that are increasing at same rate, but on corp. pays dividends and other corp. reinvests → both SH equally enrich
        ii. Vertical equity – Wealthiest in society are the ones who own assets that appreciate in value → escape tax on big part of wealth
        iii. Economic neutrality – Provides incentive to invest in corps. that retain and reinvest rather than pay out cash dividends

B. What constitutes realization (when can tax appreciation/allow TP to deduct loss)?
1. **§1001(a)**: Gain or loss occurs upon "sale or other disposition of property"
    a. Based on **Eisner** holding that sale is always realization
    b. But Congress didn't define "other disposition" b/c when tried to tax stock dividend in **Eisner** S. Ct. told them that wasn't a realization event.
        i. Point – anything short of actual sale is left to S. Ct. to decide whether realization event has occured
2. Realization events short of actual sale
    a. When TP has control over the appreciation and can separate from the investment (**Burnn** – tenant made improvements to building and LL had to pay tax on appreciation once tenant terminated lease)
        i. Although Ct. held this was a realization event, Congress has chosen to defer taxing until later (see **§§109, 119** below)

b. Rule for exchanges of property – realization occurs only if there is a "material difference" in the property exchanged (**Cottage Savings** – swapping mortgages was realization of losses b/t mortgages are materially different from another)
   i. Material difference = legal entitlements that are different in kind or extent; legally distinct entitlements
      a. In mortgage context material difference is credit worthiness of different borrowers and security by different property.
      b. Point – to get realization, just need to make factual arguments about how risks and entitlements of the properties swapped are different.

C. Realization of gains from "sale or other disposition" of property
   1. **§1001(a)** Gain from sale or other disposition of property is difference b/t amount realized and adjusted basis
      a. This is a codification of **Burnn** recognition that only realize amount that is separate from investment and realization occurs when gain control over that appreciation.
      b. Sale or "other disposition" of property always = realization event (even when its an exchange b/c in substance same as selling property and using proceeds to buy new property)
      c. Thus gain always requires 4 questions being answer
         i. How much gain or loss is **realized**?
         ii. How much gain or loss is **recognized**?
         iii. What is the **basis** of any property received in the transaction?
         iv. If any loss is recognized, is it **deductible**?
         v. Is any recognized gain or loss **a capital gain or loss**?
   2. Amount realized from sale/disposition of property
      a. **§1001(b)** amount realized = cash received plus FMV of in-kind receipts
         i. Determining value of in-kind receipts – Under the even exchange hypothesis, when 2 ptys exchange things we can assume that the two things exchanged have the same FMV.
            a. But this also requires:
               i. Parties are rational investors and
               ii. Acting at arm's length
      b. **§1001(c)** gen'l recognition rule: All realized gain or loss on sale/exchange of property is recognized unless otherwise provided.
      c. **§ 1011** gen'l basis rule: Adjusted basis = basis plus or minus adjustments
         i. **§1012** Basis generally = cost of property
            a. If there is an exchange, "costs" = FMV of property given up.
         ii. **§1016** Adjustments = adjust basis down for previous depreciation deductions, adjust basis up for costs that were not deductible

D. Special Non-Recognition and their corresponding Basis Rules
   1. Relevance
      a. If Congress grants non-recognition then TP won't be taxed on realized gain or get deduction for realized loss at that time.

b. Unrecognized gain is preserved in basis. If basis increases = tax forgiveness. If basis stays the same = tax deferral.

2. Tenant improvements
   a. **§109** GI doesn't include income, other than rent, derived by LL upon termination of the lease.
      i. Overrules **Burnn** and changes recognition on tenant improvements from termination of lease to when LL sell property.
   b. **§119** But LL does not get a basis in the improvements
      i. Although sounds like exception, it is really non-recognition b/c if LL doesn't get a basis in the improvements, he will be taxed on appreciation from the improvements when sells
      ii. But grants maximum tax deferral (TP's like!)
3. Exchange of like kind property held for productive use or investment
   a. **§1031(a)(1)** No recognition of gain or loss if:
      i. Transaction is an exchange of property for property
         a. **§1031(a)(3)** Exchange must take place w/in 180 days (concurrent requirement).
         b. Consequence – okay to use intermediary to facilitate exchanges rather than sales so long as happens concurrently (**Alderson)**
      ii. Property given up and received are held for productive use (to make $$)
         a. **§1031(a)(2)(A) - §1031(a)(1)** non recognition rule shall not apply to property held primarily for sale.
      iii. Property exchanged is of like kind.
         a. Def. of "like kind" (not statutorily defined)
            i. Real property – all real property in the US
               a. Negative implication from **§1031(h)(1)** – real property located w/in US and outside US is not like kind (b/c property is bundle of rights and rights aren't same in other countries as US)
               b. **Treas. Reg. §1.1031(a)-1(b)** – relates only to grade or kind of property and improvement are immaterial.
            ii. Tangible and depreciable personal property – same gen'l asset or products class (**Treas. Reg. §1.1031(a)-2(b)**)
               a. E.g. office furniture for office furniture; car for car
            iii. Intangible or non-depreciable person property – similarity as to the underlying nature and risks of the investment (**Treas. Reg. §1.1031(a)-2(c)**
               a. E.g. copyright of novel for copyright of similar novel
   b. **§1031(d)** Basis in property acquired = Basis in property given up – cash received + recognized gain – recovered loss.
      i. This means basis in property received is going to be the same as basis in property given up (unless get $$ too) and will be taxed on appreciation when sell. Tax Deferral, not tax forgiveness!
      ii. Test for basis calculation: FMV if TP sold right after acquired in exchange less basis should always be the same as realized gain.

4. Exchange of like kind property + "boot"
    a. **§1031(a)(1)** does not grant non-recognition because it only applies to exchanges of solely like kind property
    b. Non recognition of gain if:
        i. **§1031(b)** If exchange is like kind property + boot (other non like kind property or money) → gain (not loss) will be recognized but only up to the FMV of the boot
    c. **§1031(d)** Total basis in property acquired (both the like kind property and the boot) is computed same way as above.
        i. But also need to allocate the total basis amongst the like kind property acquire and boot – second sentence of **§1031(d)**
            a. Basis in boot = FMV of the boot
            b. Basis in like kind property acquired = Total basis – basis in boot.
    d. **§1031(c)** If total transaction (in kind property + boot) results in a loss → loss is not recognized
        i. This applies to both the in kind property and the boot
        ii. Why tax gain on boot but grant deferral on loss from boot?
            a. If tax gain/loss on sale then TP has complete control over when they get taxed on gain or can take loss deductions.
    e. Note – if the boot is personal property to use to improve the land, could make a substance over form arg. that it should be considered "like kind"
        i. But this will fail b/c bright line rules Congress has developed for defining in kind property (only real property held for investment)
        ii. By not recognizing losses on exchanges of property (including when boot is involved) then provides incentive for TP to sell property declining in value rather than exchanging
            a. B/c when sell, can loss is recognized and TP can take the deduction immediately and use the proceeds to buy the property she wants.
5. Involuntary Conversion
    a. Involuntary conversion = theft, destruction, and condemnation
    b. **§1033(a)(1)** If property is involuntarily converted into property similar in use → no gain shall be recognized
    c. Optional non-recognition if:
        i. **§1033(a)(2)** Property is involuntarily converted into money → TP has option to not recognize that portion of gain which he reinvests in similar property to replace the converted property if:
            a. Replacement property must be of similar use
                i. This is a more rigid standard than "in kind" which covers any real property for real property swap.
                ii. Test: Property is the functional equivalent (common usage)
                    a. Look to TP's intent for the previous land and the new land – is he intending to use it for the same purpose
                iii. If only portion of replacement property is similar use, then portion of gain which went to portion of property that IS NOT similar use must be recognized

b. Makes the purchases w/in the following time period:
    i. Beginning w/ date property was converted OR threat of conversion was imminent
        a. No def. of imminent conversion, so need to argue the facts under common usage.
    ii. Ending 2 yr. after close of taxable yr. that gain from conversion was realized.
        a. Remember amount realized is only amount that exceeds basis (cost). So if city made 1st payment that only covered TP's basis, amount realized wouldn't kick in until after City made another payment that exceeded TP's basis
c. Note – only the portion of the GAIN (amount realized – AB) , not the amount realized which is reinvested in similar property may be non-recognized.
    i. Ex. TP owns prop. with basis of $1mil. and is involuntarily converted into $1.5mil cash (FMV). Gain is $500K. If TP purchases similar property for $1.2mil, he can choose not to recognize $200K (that portion of gain that used to reinvest) but must recognize $300K (that portion of gain that didn't reinvest).

ii. **§1033(g)** If involuntarily converted property was held for productive use in a trade or business or for investment:
    a. **§1033(a)** optional non recognition rule applies AND
    b. Revert back to like kind standard AND
    c. Get 3 yrs. to use proceeds to purchase replacement property
    d. NOTE – This rule only applies to condemnation, not destruction through theft or acts of GOD.

d. **§1033(b)** Basis in replacement property
    i. **(b)(1)** If property involuntarily converted into property of similar use (under **(a)(1)**): Basis = basis of old property +/- gain or loss recognized (if also received money)
    ii. **(b)(2)** If property involuntarily converted in money that is reinvested in similar property (under **(a)(2)**): Basis = cost of replacement property – unrecognized gain.

6. Sale of principle residence
    a. **§121(a)** GI does not include income from sale/exchange of property owned by TP and used as principle place of residence
        i. Limits
            a. Must be used as principal place of residence in at least 2 of last 5 yrs.
            b. **(b)**Maximum $250K exclusion if single or $500K exclusion if married and file jointly.
        ii. Because there is no corresponding basis rule – this is tax forgiveness, not tax deferral!!!
    b. Policy for the exclusion

        i. Many sales of residence are because of job relocation – same as involuntary conversion.
        ii. Appreciation could cause Capital Lock-in
        iii. **§1014** grants tax forgiveness at death anyway – so want to let elderly sell home before die and enjoy the proceeds.
        iv. Simplicity – don't have to worry about complicated basis rules
        v. Incentive to sell home when its approaching the maximum exclusion cut-off.
  7. Policy for non-recognition rules
     a. Administrative convenience – Valuing disposition of property based on an exchange for other property causes controversy over appraisal
     b. Liquidity concerns – When exchange property, TP may not have the readily available cash to pay tax on appreciation
     c. Horizontal equity – Swap of property is (technical realization event) is very much like continuing to hold onto original property, which is not a taxable event.
        i. Substance over form – mere technical realization event is not sufficient in substance to change nature of the investment
     d. Economic neutrality – Avoid capital lock-in
        i. Capital lock-in = TP doesn't sell investment to switch to a better investment b/c after sale and tax TP isn't left with enough cash to purchase the better investment.
     e. Why not grant non-recognition for exchanges of non like kind property, like stocks?
        i. No admin. convenience issue – stocks provide easy FMV measure
        ii. Practicality – if granted non-recognition for property like stocks then there would be indefinite tax deferral b/c continually swap stocks.
           a. Congress only intended non-recognition rules to be tax deferral, not tax forgiveness
        iii. Theoretical – Stocks are never like kind b/c they represent an interest in a company and no 2 companies are alike
     f. Why stricter non-recognition rules for involuntary conversion (must be similar in use) than for voluntary exchanges (must only be like kind)?
        i. No admin. convenience issue – ready mode of valuation when property involuntarily converted to cash
        ii. No liquidity concerns – TP gets cash for involuntary conversion
        iii. No economic neutrality concerns – Capital lock-in effect not in play with involuntary conversion b/c TP doesn't have the option to retain original investment
        iv. Only horizontal equity concerns persist – If there hadn't been an involuntary conversion, TP would have continued to hold original property w/ unrealized appreciation.

E. Losses
  1. Losses are just a negative gain (computed the same way under **§1001(a)**)
  2. General Rule

a. **§165(a)** There shall be allowed a deduction for any loss sustained during the taxable year
   i. But for the loss to be deductible there needs to be a realization event (**§1001(a)** must kick in).

3. Limits - **§§ 161, 261** – if one provision allows a deduction and another provision disallows the deduction, then the deduction is disallowed.
   a. **§162(c)**Loss must be incurred in:
      i. **(1)** a trade or business or
      ii. **(2)** transaction entered into for profit (investment transaction)
   b. **§267(a)(1)** No deduction allowed (disallowance) for losses that occur in "direct or indirect" transactions b/t
      i. **(b)(1)** Family members
         a. **(c)(4)** Def – brothers, sisters, spouse, ancestors, and children
         b. Rationale – don't want to allow party's to shift loss deductions to higher income family members
         c. **(d)** Exception to loss deduction forfeiture - if transferee family member later sells to an unrealated party for a gain → only recognize portion of gain that exceeds the transferor family member's previous loss (defers the loss deduction to the transferee family member).
            i. Ex. Sell stock to brother for $20 loss. You get no deduction. Brother sells stock to 3d pty for $30 gain → only $10 gain is recognized.
      ii. **(b)(2)** An indiv. and a corp. which that indiv. owns more than 50%
         a. **(c)(2)** An indiv. is considered to own the stock owned by his family members
            a. This means no loss deductions for transactions b/t an indiv. and corp. which his family member owns more than 50%
      iii. Note – "directly or indirectly" language means that family members can't get around disallowance rules by conducting transaction on the open mkt (e.g., brother sells on NYSE and sister buys on same day)
   c. **§1091(a)** Dissallowance for wash sales – sell for a loss then and purchase same stock w/in 30 days before or after date of sale.
      i. **(d)** Basis rule: Basis in new stock = basis in old stock + (purchase price of new stock – sales price of old stock).
         a. Basically this just puts your basis in the new stock at cost plus your loss which was disallowed
      ii. Because there is a basis rule this isn't true loss disallowance, its just loss deferral (whenever there's a basis adjustment its always a matter of timing, not forgiveness/disallowance)

F. Special Rules for Capital Gains and Losses
   1. **§1222(11)** def. of "net capital gain": Net long-term capital gain for the year – net short-term capital gain for the year
      a. **(3), (4)** def. of "long-term capital gain/loss": Gain/loss from sale/exchange of capital assets held for more than 1 yr.
      b. **§1222(a)** def. of "capital assets": Property held by the TP

        i. Incredibly broad definition – includes EVERYTHING that you own
        ii. Only a few carveouts:
            a. **(a)(1)** Inventory held for sale to customers
2. Treatment of capital gains
    a. **§1(h)** Sets out reduced tax rates that apply to net capital gain (usually 15% tax rate)
        i. Point – almost anytime you sell something, **§1(a) – (c)** tax rates don't apply and only taxed at 15% on those gains
        ii. **§1(a) – (c)** only apply to ordinary income: labor income, interest, royalties, rent, compensation
            a. dividends used to be part of ordinary income but now considered a capital asset
3. Policy for preferential treatment of net capital gains
    a. Taxing inflation – When sell property amount realized is based on today's dollar which have inflated since you paid for you basis in the property. So by only allowing proceeds to be offset by basis → treats the inflation as real income.
        i. Tax policy is violation if tax gain due to inflation rather than just gain which represents increase in resources available for consumption or savings.
        ii. Problem w/ justification – could also fix this by adjusting the §1 rate schedule annually
    b. Vertical equity concern in bunching income – Realization requirement forces tax all in one year on appreciation that has slowly built up over time (bunching). That bumps up TP's bracket for that year even if ordinary income is relatively low
        i. Problem w/ justification – sometimes bunching is fair b/c TP was actually enriched that much in that taxable year and capital gain preference doesn't distinguish b/t fair and unfair bunching.
    c. Mitigate capital lock-in – Concern property owners will be deterred from selling by immediate tax on all gains, when they can easily deter tax by not selling
        i. This is the core justification for lower capital gain rates.
        ii. Problem w/ justification – could just grant gen'l non-recognition rule if reinvested gain from sales of all property. But TP's could abuse this by continuing to reinvest thereby getting tax forgiveness instead of deferral.
        iii. Lowered capital gain rates strikes a compromise by mitigating capital lock-in effect but also ensuring TP's won't get complete tax forgiveness.
4. Treatment of capital losses
    a. **§§ 165(f), 1211(b)** Can only deduct capital losses to offset capital gains (can't offset against ordinary income)
        i. Exception – if no capital gains, can offset against up to $3K in ordinary income
        ii. Can also carry over excess capital losses to the next tax year

iii. Outcome – you can keep carrying excess losses over year after year offsetting it against $3K in income until there are no more excess losses

b. Justification for unfavorable treatment of capital losses.
    i. Capital gains get such preferential treatment, it is good to have a bit of a penalty for capital losses
    ii. B/c TP's have control over when realization occurs, the capital losses penalty incentives not realizing capital losses until also have capital gain to offset.
        a. This is the primary justification.

V. Loans and Offsetting Claims

A. Loans in general
1. Definition of a loan (threshold question for tax liability of discharge of loan)
    a. **§108(d)(1)** Def. = Indebtedness for which TP is liable or for which he gets property in return
        i. **Kirby Lumber** interpretation – consensual unconditional obligation to repay
        ii. Contrary to **Zarin** holding, this DOES NOT need to be a legally enforceable transaction
            a. **Zarin** holding – discharge of gambling debt not income b/c not legally enforceable in state where debt incurred.
            b. Why Zarin was decided wrong
                i. Horizontal equity – TPs in state where gambling debt is enforceable will be taxed on settlement of that debt or TP's the choose to repay will be suffer greater disenrichment
                ii. If not legal obligation to repay → proceeds received would be taxable.
                iii. **§165(d)** – losses from wagering transactions are deductible, but only to offset gains from wagering
                    a. Zarin allows gambling losses to offset what should have been ordinary discharge of indebtedness income.
                iv. **§441(a)** – Taxable income computed only on basis of taxable year
                    a. Zarin allows TP to offset prior years gambling losses against what should have been discharge of indebtedness income in succeeding taxable year.
            c. Arg. that **Zarin** was decided right – Casino credit extension to gambler is not true loan b/c compulsive gamblers are "addicts" and don't get same benefit from extension of credit that rational TP's get.
2. Attributes of loan
    a. Issuer/debtor receives proceeds in exchange for obligation to repay w/ interest.
    b. Creditor can freely transfer the evidence of indebtedness that he has purchased to a 3d pty on the open mkt.

i. If mkt interest rates have dropped since creditor purchased the obligation to repay (e.g., bought a bond), then creditor would only sell that bond for a higher price then face value (b/c only alternative on the mkt is for 3d pty to buy lower interest rate bonds)
ii. If mkt interest rates have increased since creditor purchased the bond, then creditor would only be able to sell that bond for a lower price than face value (b/c alternative on the mkt is for 3d pty to buy higher interest rate bonds).

B. Tax treatment of Loans
1. Loans proceeds are not income to the borrower (**Kirby Lumber**)
a. No enrichment w/ loan proceeds b/c also include offsetting obligation to repay.
2. Repayment of principal is not deductible

C. Tax treatment of discharge of indebtedness (paying/buying back loan for less than full obligation/face value)
1. **§61(a)(12)** Discharge of indebtedness is taxable income (codifies **Kirby Lumber** holding)
a. Rationale
i. Substance over form
a. Form – Even though able to repurchase loan for less than face value is due to increase in interest rates
b. Substance - In substance TP is receiving portion of loan proceeds w/out corresponding obligation to repay.
ii. Enrichment – TP is receiving enrichment from discharge of indebtedness by having assets freed from claims of creditors
iii. Recapture – When indebtedness discharged it makes the rationale for not taxing loan proceeds (corresponding obligation to pay) disappear → need to "recapture" prior income that went erroneously untaxed.
a. Conceptually this is an extension of the tax benefit rule.
2. Exceptions to discharge of indebtedness rule
a. Insolvency exception
i. Prior common law exception – If debtor corp. is insolvent then no taxable income from discharge of indebtedness.
a. But must be insolvent both before and after discharge of indebtedness
b. Justification - Enrichment rationale for taxing discharge of indebtedness disappears w/ insolvency cases
i. If corp. still insolvent after discharge of indebtedness → shareholders (who are the true corp.) receive no benefit from the discharge
ii. This looks at debtors total financial situation to determine whether enriched from the discharge
c. Notice – this is complete tax forgiveness
d. Counter arg. – Recapture rationale persists in some cases of insolvency

            i. SH do receive value even if corp. stays insolvent b/c they discharge their loans rather than liquidating, which frees up any claims on the corp. assets and gives them chance to make corp. profitable again.
                a. This looks at whether debtor is enriched from the discharge in isolation
        ii. **§108(a)(1)** If TP is insolvent, GI does not include income from discharge of indebtedness (codifies the principle of the insolvency exception)
            a. Items that differ from common law insolvency exception
                i. **(d)(3)** Need only be insolvent at time of discharge (changes common law requirement that must remain insolvent after discharge)
                    a. Insolvency = liabilities are greater than FMV of assets
                ii. **(a)(3)** But exclusion limited to amount that TP is in the red.
                iii. **(b)** Discharge of indebtedness must count against the corp's NOL and carry over deductions (the **§172** Sanford & Brooks deductions)
                    a. **(b)(3)(B)** But discharge of indebtedness income will only count against carryover losses at the rate of 33/13 cents to the dollar.
                        i. Congress merely recognizing that deductions are not dollar for dollar, but depend on TP's tax rate (usually 33% for corps.)
                iv. Point – unlike common law exception, this is just a timing issue. TP gets exception in yr. that discharge occurs, but doesn't get to carry forward loss deductions to successive years.
                v. **(e)(1)** Common law insolvency exception is no longer to be used.
            b. Justification
                i. **Focuses on recapture rationale** (look at enrichment from discharge in isolation) rather than enrichment rationale (looks at TP's total financial status to determine whether enriched from discharge).
                ii. **Point – Congress is telling us that they are using recapture rationale only to justify discharge of indebtedness inclusion and exclusion**.
    b. **§108(e)(5)** Purchase price adjustment
        i. Debt incurred in purchasing property that is later reduce is just treated as reduction in purchase price (not taxable discharge of debt income)
            a. The debt must arise out of purchase of property
            b. TP must be solvent
3. Discharge of indebtedness that is not income
    a. Discharge of indebtedness where TP didn't receive a corresponding benefit at time indebtedness occurred

i. Examples
   a. Discharge of promises to make a gift
   b. Discharge of obligation to repay a disputed fee for a personal service (e.g., lawyer's fees)
ii. Justification – recapture rationale income requires that TP received a benefit (e.g., proceeds when the transaction is a loan) that corresponded to the indebtedness obligation
   a. When indebtedness is gratuitous or disputed, then when that indebtedness is discharged there is no prior enrichment which needs to be taxed ex post.

b. Indirect satisfaction of the indebtedness
   i. Examples
      a. ER pays EE's tax liability (Old Colony facts)
      b. Creditor agrees to discharge debt in return for in-kind property or service
   ii. Justification – Debt is not being forgiven, its being paid in a way that was different than originally contemplated.
      a. Substance over from – unscramble the scrambled transaction

D. Conditional obligations to repay (not a loan b/c loan requires "unconditional" obligation to repay)
   1. Claim of right doctrine – Receipt of proceeds without restriction on use by TP who makes a claim to those proceeds but another pty is disputing that claim
      a. Taxable as income in the year of receipt (**N. American Oil** – had to pay tax on proceeds received from lawsuit in yr. receivership paid out, even though other party was appealing decision)
      b. If later TP looses claim and has to repay → deduction for yr. have to repay (**Lewis**)
         i. Problem – If tax rates in year that claim deduction have gone down since year that included disputed income → deduction won't make TP whole (this is what happened in **Lewis**)
         ii. **§1341** Solution to inequity – TP has choice whether to take a deduction for the repayment or claim a credit for the tax on the income that shouldn't have been included
            a. Outcome
               i. If tax rates decrease → will always choose the credit
                  a. This scenario address the inequity of **Lewis**
               ii. If tax rates increase → will always choose the deduction
                  a. In this scenario IRS is getting less than they should but Congress willing to accept that
      c. Justification for claim of right doctrine
         i. **§451(a)** Must reporting income using cash receipts and disbursements method – income is reported in year of receipt and get deduction in year required to pay it back.
            a. Constructive receipt doctrine – year of receipt = year have right to collect money if so choose
            b. Point – follow the money

            c. This is the default accounting rule. Can use accrual method if, but only if show that is customary accounting method TP has been using.
        ii. An offsetting claim (contingent obligation to repay) to the proceeds is not enough to treat it like a loan
            a. Obligations to repay loans are unconditional (**Kirby Lumber**)
            b. Offsetting claims, because they are resolved by litigation, have a lower expected value than amount of proceeds received (litigation will probably settle for less than face value of offsetting claim)
            c. If allowed tax deferral on proceeds subject to offsetting claims → would turn into tax forgiveness b/c could always claim everything you receive is subject to somebody's claim
        iii. Administrative convenience
            a. Can't police transaction based on following when SoL run for different claim and SoL differs from state to state
        iv. TP receives some enrichment from use of proceeds for short time, even if eventually has to repay
    d. Exception – if can establish that TP consistently uses accrual accounting method for business purposes, then can report proceeds in accordance with that method
        i. **§446(h)** Accrual Method – Report income in year all events have occurred that fix TP's right to receive income and get deduction in year all events have occurred that est. fact of liability to pay.
            a. **N. American Oil** didn't get to use this method b/c couldn't provide evidence of consistency.
2. Tax treatment of embezzlement funds
    a. Proceeds are taxable in year of receipt just like claim of right doctrine treats disputed proceeds (**James**)
        i. Justification
            a. Factual condition on repayment – It is very unlikely criminal will get caught or have funds to repay debt, which makes it more factually similar to disputed funds.
                i. Even though legally embezzled funds are more like a loan – unconditional obligation to repay – the factual similarity to disputed funds carries the day
    b. If TP gets caught and has to repay → no deduction allowed (**McKiney**)
        i. Justification
            a. **§1341** deduction/credit for repayment of disputed funds requires that at the time funds were included and taxed it "appeared TP had an unrestricted right to such funds"
                i. It never appears that embezzlers have an "unrestricted right" to the funds
3. Non-Recourse loans
    a. Def. – Non-Recourse loan is a loan that is secured by collateral only and creditor does not have legal ability to go after debtor's other assets if debtor defaults.

        i. This could be viewed as either a conditional or unconditional laon
            a. Conditional loan – Could view NRL as repayment conditioned upon value of collateral staying above value of the loan.
                i. Unlike unconditional loans where if debtor defaults, creditor can go after debtor's personal assets.
            b. Unconditional loan – Could view as unconditional loan with advance agreement by creditor to discharge indebtedness if collateral value falls below principal of the loan
                i. This is the view that courts/Congress have adopted b/c very rarely is there going to be a default on NRL (lenders wouldn't expose themselves to that risk).
    b. Tax Treatment – treated just like unconditional loans, despite debtor limited obligation to repay.
        i. Proceeds – tax free
        ii. Repayment of principle – not deductible
        iii. Discharge of indebtedness – taxable as follows:
    c. Judicial application/Policy - need ensure that sale/disposition of property under **§1001** accurately catches up w/ previously untaxed gain (only necessary b/c **Eisner** realization requirement)
        i. Remember under **§1001** gain from sale = amount realized - basis
        ii. Basis of property = cost (tax paid investment)
            a. This including loans used to purchase the property, regardless of how that loan is secured (whether R or NR)
        iii. **(b)**Amount realized = money + FMV of property received
            a. Problem – could structure a sale so that buyer just pays off seller's mortgage instead of paying him cash or property
            b. Solution - "Property received" must be read to include seller's promise to pay outstanding mortgage owed on property sold w/ FMV of the promise being the same as balance owed on mortgage (**Old Colony** – unscramble the scrambled transaction)
                i. Otherwise, if buyer just paid off mortgage, seller's amount realized would be below FMV and we know that is wrong b/c no rational investor sells for below FMV
            c. Inclusion of outstanding loan principle is necessary under this solution whether that loan is R or NR (**Crane**).
            d. This is so even when FMV of property sold has fallen below principle owed on mortgage – which would deem an amount realized greater than FMV of property (**Tufts**)
                i. Rat. – unscramble the transaction
                    a. If value of property used to secure NR loan has fallen below principal of loan → the TP is going to get that portion of outstanding principal tax free (b/c didn't have to pay tax on proceeds and won't have to pay back)
                    b. Thus, taxing gain not from sale of property but from discharge of indebtedness.

iv. In this manner, discharge of indebtedness income is just being tax on disposition of the collateral property.
   a. Notice – this gives debtor more favorable tax treatment b/c discharge of indebtedness income is being taxed as capital gain (lower tax rate)

d. **§7701(g)** Codification of Tufts - In determining gain or loss under for property, FMV is never less than amount of any NRL for which the property serves as capital.
   i. Also codifies **Tufts** wrongly characterizing discharge of indebtedness income on NRL as a capital gain rather than ordinary income.

Tax Treatment of offsetting liabilities

	Income Focus	Cash-Flow Focus
Proceeds	Not Income	Income
Principal repayment	Not Deductible	Deductible (disputed proceeds only; not embezzles proceeds)
Principle forgiveness	Income - §61(a)(12)	Not income, not deductible
Policy	No enrichment unless debt forgiven; Recapture; Admin Conv.	TP Convenience (liquidity)
Examples	Loans – Recourse & Non-Recourse	Claim of Right; Embezzlement
Preference	TP's prefer b/c delays tax liability	IRS prefers

<u>**The Proper Taxpayer (Progression Problems)**</u>

I. Gifts and Bequests

A. Theoretically correct tax treatment of gifts/bequests
   1. Donee – Gifts should be taxed as income
      a. Increase in resources available for consumption or savings
      b. **Glenshaw Glass** – windfalls are always income
   2. Donor – Should get a deduction (like loss or theft under **§165**)?
      a. Arg. for allowing deduction – Material Consumption – Donee, not donor, is the one who is getting the consumption benefit of the gift.
      b. Arg. for taxing donor – Intangible Consumption – Donor not disenriched like a loss or theft, it is actual a purchase (consumption) of intangible satisfaction of giving a gift (wouldn't give gift if not getting anything out of it)

B. **§102(a)** Statutory tax treatment of gifts/bequests upon receipt
   1. Donee – Excludes from GI FMV of property received as gift, devise, or bequest
   2. Donor – Default is no deduction unless allowed by statute
      a. Only deduction allowed is **§170** Charitable contribution
      b. Point – Donor, but not donee has the tax consequence.

3. Justification for statutory approach that adopts none of the theoretically correct approaches
    a. Administrative Convenience
        i. If allowed donee deduction based on material consumption rationale it would allow for large transfer of wealth to lower tax bracket family members – tax avoidance
            a. To overcome this IRS would have to conduct massive audits to ensure that donee's resources aren't being used for benefit of donor
        ii. If taxed both donee and donor then provides incentive for them to conceal transaction – tax revenue loss
            a. To overcome this IRS would have to tax on an honest system
    b. It is the second best approach
4. Exceptions
    a. **§102(b)(1)** Income that comes from property given as a gift/bequest is not excluded
        i. Ex. If get gift of stock, dividends later received on that stock are not excludable as gifts.
        ii. This also includes accounts
    b. Split interest gifts/bequests
        i. Definitions
            a. Life/term tenant = person who receives interest income in trust/property
            b. Remainderman = person who receives entire trust/property upon termination of life/term tenancy
        ii. **§102(b)(2)** If give gift of property to one person (remainderman) and interest in the income from that property to another (life tenant) person, only the property itself is excludable as a gift, not the interest in the income
            a. Point – life tenant gets no exclusion, remainderman gets whole exclusion
            b. Ex. If money in a trust, with A getting the money in 20 yrs. and B getting the interest income earned on the trust during the next 20 yrs., only A's gift is excludable (**Irwin v. Gavit** holding)
        iii. **§273** Donee of life estate does not get any depreciation deduction
            a. Compare to **§167** depreciation deduction for purchaser of life estate - Purchaser of a life estate gets pro rata depreciate deduction spread out over expected life of the estate
            b. Point - **§273** is just a reiteration of **§102(b)(2)** b/c if allowed depreciation deduction that would be a type of "income" from the property
                i. This is so even where TP has a disputed claim over inheritance of property (excludable) and settles with estate by taking a life interest in the property (**Early** holding)
                    a. Even though this can be seen as a scrambled transaction (sold inheritance property and purchased life estate) courts typically view as a settlement of disputed claim.

C. Statutory tax treatment of basis in gift/bequest

1. Is giving a gift a "realization event" so that donor/decedent's estate has to pay tax on appreciation in value?
   a. Same arguments as made under **§102(a)**
      i. Material consumption – donor/decedent not being enriched by previously unrealized appreciation when makes gift.
         a. And can't tax donee on unrealized appreciation per **§102(a)**
      ii. Intangible benefit – donor/decedent is being enriched somewhat from intangible satisfaction of making gift and separation of risk from transaction (realization event under **Burnn**)
2. Basis in intervivos gifts (gifts given while alive)
   a. **§1015(a)** Transfer basis rule - Donee gets donor's basis in the property
      i. Point – Donee pays donor's unrealized appreciation when donee sells the gift.
      ii. Note – Thus this is only tax deferral, not tax forgivness (always know its deferral and not forgiveness when there is a correspond basis rule)
         a. But not only does allow tax deferral, but also allows appreciation to be taxed at lower rate b/c gifts always flow from higher to lower income individuals
   b. Exception – **Second clause of §1015(a)** – Donee gets FMV at time of gift as basis if:
      i. Two conditions must be met
         a. Donor's basis at time of transfer is greater than FMV AND
         b. Donee is selling the property for a loss
      ii. Note – Donee, not donor, is the one who gets the loss deduction
         a. Rat. – Prevent donor's from shifting loss deductions that they would be entitled to if they sold to individuals in higher tax brackets by making a gift of the property instead of selling
            i. This works b/c by donee assuming FMV at time of gift, the loss deduction disappears at time gift is made.
   c. Special Basis rules for split interest
      i. Life/term tenant – **§1001(e)(1)** basis is $0
         a. Must be this way b/c **§§102(b)(2), 273** say that life/term tenant is not going to get any tax free income from gift → taxable in full
      ii. Remainderman – **Treas. Regs. §§1.1014-5, 1.1015-1(b)** Donor's full basis in property transfers to Remainderman, but not until the property reverts from the life/term tenant to Remainderman.
         a. Remainderman's basis prior to reversion – if sells b/f takes possession (when gets donor's full basis) then basis calculated as PDV of basis relative to the life/term tenanat
3. Basis in bequests (inherited gifts)
   a. **§1014(a)** Step up basis - Transferee gets FMV of bequest at time of decedent's death
      i. Exception - **§1014(c), §691** – If receive gift of right to receive income, step up basis rule does not apply and basis is $0
         a. Point – only gifts of property get tax forgiveness

        b. Ex. TP inherits decedent's accounts receivable. TP's basis is $0, so when he collects ARs he will be taxed in full on the income.
    ii. Outcome of step up basis
        a. All previously unrealized appreciation is tax free – outright tax forgiveness
        b. But if property has declined in value that loss deduction will also be forfeited
    iii. Message
        a. Sell property that has declined in value before you die
        b. If don't recognize gain on disposition of property intervivos, that unrecognized gain could go untaxed (concern of decent in **Eisner**)
            i. This is why IRS applies non-recognition rules very strictly.

b. Policy for tax forgiveness at death of previously unrealized appreciation
    i. Avoid double taxation – decedent's estate will get hit by estate tax anyway
        a. But income tax and estate tax have different basis and tax rate rules and serve different policies
    ii. Liquidity concern – beneficiaries may not have money to pay tax upon receipt of inheritance, which could force them to sell the inherited property just to pay the tax
    iii. Capital lock-in – requiring beneficiary to pay tax on unrealized appreciation could discourage from selling to switch investments b/c after tax money would not be enough to purchase similar investment.
    iv. Notice – unlike other tax favored transactions (e.g., capital gains, housing incentive, medical insurance), tax forgiveness at death has not independent social policy justifications – BIG PROBLEM

c. Possible solutions to correct favorable tax treatment of the wealthy (b/c only wealthy are the one's own property to devise upon death)
    i. Use **§1015** carry over basis, just like intervivos gifts – solves liquidity concern b/c not taxed until sell.
        a. Problem – greatly exacerbates capital lock-in effect
    ii. Realize appreciation upon death and tax to decedent's estate – solves capital lock-in b/c no unrealized appreciation to tax when beneficiary decides to sell
        a. Problem exacerbates liquidation problem.
    iii. Result – policy paralysis b/c both solutions are contradictory
        a. Prof. thinks a good solution is to provide for realization at death (solves capital lock-in) but provide for installment payments of tax on realized gain (solves liquidity problem).

d. Congressional solution - **§1022** takes effect in '09
    i. **(a)** Beneficiary receives decedent's basis in property inherited
        a. This is just like **§1015** transferred basis for intervivos gifts
        b. But potential of exacerbating capital lock-in
    ii. **(b)** Increase carry over basis by $1.3 mil for bequests to indiv. and $3 mil. for bequests to spouse

            a. Solves capital lock-in problem of transferred basis by granting tax forgiveness for up to $3 mil. in gains.
        iii. Point – only the ultra wealthy will bet taxed

D. Determining whether the transfer is a gift or not – threshold question

1. Judicial Def. of "gift"
    a. Primary purpose test – Whether transfer primarily motivated by:
        i. Force of legal or moral obligation (not a gift) OR
            a. e.g., feel indebted to someone b/c they have been helping your business so give them a car (**Duberstein**)
        ii. Detached and disinterest generosity (gift)
            a. e.g., want to thank a departing EE for a job well done (**Duberstein** companion case)
    b. This is a totality of circumstances test, but all or nothing because have to determine primary motivation and that is what governs
        i. Only look at motivations of transferor, even though tax consequences flow to transferee and transferee may not even know what motivated the transfer
    c. Test adopts plain meaning of gift b/c Congress did not define
        i. Even though IRS advocated brighline rule that transfer in employment context can never be a gift (S. Ct. recognized that plain meaning still allows for gift in employment context b/c co-workers become friends)
2. Congress response:
    a. **§274(b)**
        i. Defines "gift" as "any item excludable" under **§102**
        ii. Explicitly states no deductions for giving gifts
        iii. Outcome – whenever intervivos transfer, one side is always going to have tax consequences
            a. Application
                i. Transfer is a gift
                    a. Donor gets no deduction (**§274(b)**)
                    b. Donee gets to exclude (**§102**)
                ii. Transfer is not a gift
                    a. Transferor may claim biz. exp. deduction (**§162**)
                    b. Tranferee must tax on the income (**§61**)
            b. Also works as administrative convenience b/c if transferor takes deduction and transferee claim exclusion, provides motivation for transferee to testify that motivation was not gratuitous.
    b. **§102(c)** No amount transferred from ER to EE is excludable as a gift
        i. Congress getting closer and closer to adopting brightline standard IRS advocated in **Duberstein**

II. Assignment of Income

A. Income from services – Always taxable to the person who earns it

1. This is so even if TP enters a K b/f income is earned, which assigns the rights to his income to a 3d pty (**Earl** – Husband K w/ wife that wife entitled to ½ income earned did not change fact husband still one who had to pay taxes on all his income

2. Justification
    a. Prevent tax avoidance - If able to assign income, would allow wealthy to assign income to lower tax bracket family members
    b. **§102(a)** Taxes gifts to donors, not donees. B/c assignment of income by K is a gift, donee does not get taxed on that income so much tax donor on all.

B. Income from property – Taxable to the person(s) who owns the property

1. Justification (**Poe** – In state that called for all property owned by married indiv. to be joint property (community property), income was split b/t the husband and wife – exact opposite of Earl)
    a. Ownership - **§1** use of word "of" connotes ownership, so all owners of the property also own the income of the property
        i. "of" is given plain language meaning (same issue that arises in kiddie tax)
    b. State law – Income splitting by K is irrelevant for tax purposes (**Earl**) but income splitting dictated by state law must be respected for tax purposes
2. Result joint property rule – est. a "marriage bonus" disparity
    a. If lived in a community property state → got to split that income b/t husband and wife.
        i. Result – Disparity to married couples who didn't live in community property state
    b. Congress enacted Split Income provision – Gave marriage bonus to all couples, regardless of state law.
        i. Result – Disparity b/t single TP who earns same amount as married TP
    c. Congress enacted Separate rate schedules – When 2 single ppl. w/ comparable income marry they were subject to mandatory increased rate schedule
        i. Result – Est. "marriage penalty" for marrying someone who earns same as you, but still "marriage bonus" disparity for marrying someone who doesn't earn as much money as you.
    d. Current framework
        i. **§1(f)** Lowest tax brackets (10%, 15% tax rate) for married couples filing jointly is twice as wide as that of single TP; but upper brackets are not quite as wide and highest bracket is the same size as single TP
        ii. **§63(c)(2)** Standard deduction for married couples filing jointly is double that allowable for single TP
        iii. Result – still a marriage bonus, but only for low income families.
    e. Policy for allowing favorable tax treatment of married indiv.
        i. Admin. Convenience – difficult to trace what about of income came from what spouse.
3. What if ownership interest in the property is unclear? (not responsible for knowing these rules)
    a. **§671** If treated as owner of a trust → must pay tax on income from the trust
    b. **§673(a)** Grantor treated as owner of any portion of trust which he retains a reversionary interest

c. **§674** Grantor treated as owner of any portion of trust which he retains right to choose the beneficiaries
d. **§675** Grantor treated of any portion of trust which he retains managerial powers
e. Point – Only way to avoid tax liability is to ensure that no strings are attached when dispose of property
   i. IRC only looks to beneficial ownership and control, regardless of what state property law says.

III. Property Transfer in Divorce Contexts

A. Tax Treatment of Property Settlement

1. Judicial Treatment:
   a. Trasnferor taxable on appreciation in value of property when transfers to ex-spouse in divorce settlement (**Davis** holding)
      i. There has been a realization event under **Burnn**
         a. Husband is freeing up his assets and buying peace w/ wife (separation of risk)
         b. Same thing as buying release from legal claims w/ the property (Old Colony)
      ii. How to measure amount of gain?
         a. Applying **§1001** literally we need to know the FMV of release of legal claims (that is amount realized).
         b. Use even exchange hypothesis – 2 rational ptys wouldn't agree to an exchange unless though value of property giving up and value of property received was the same.
            i. Potential problem that ex-spouses aren't acting at arms length (mandatory assumption for even exchange hypoth. to work), but b/c they are getting a divorce we can assume they are acting in their own best interest.
      iii. How to calculate transferee's basis in property acquired?
         a. FMV at time of receipt (**Farid**)
            i. Must be FMV b/c transferee's receipt of property is a tax free settlement of claims (see below) and only way to ensure that its tax free is if transferee gets basis of FMV at time of receipt (otherwise would have to pay tax on the previously unrealized gain when transferee sells)
         b. Notice – In **Farid** IRS was arguing that basis should be carry over like a gift (brighline rule for transfers in marriage context). But ct. rejected their brighline rule just like rejected brighline rule for employment context.
   b. Transferee not taxable on receipt of property received
      i. Property received is in settlement of damage claims so need to analyze under **Raytheon** – in lieu of what were damages received
         a. Future in-kind support – replacement living expense would not have been taxable if received during course of marriage
         b. Loss of consortium – not taxable imputed income

            c. Expectancy of hare of property when spouse dies – tax free on receipt (**§102**) and later disposition (**§1014** step up basis
        ii. Point – damages are received in lieu tax free income!
2. Congress response to **Davis** & **Farid** – Statutory Rules
    a. **§1041(a)** No gain or loss shall be recognized for the transfer of property from a spouse incident to divorce.
        i. Nonrecognition rule for transferor (overrules **Davis**)
    b. **§§1041(b)(1)** Property transfer treated as a gift
        i. Receipt of property by transferor is tax free (**§102** gift rules)
        ii. **(b)(2)** Transferee get's transferor's carry over basis
        iii. Point – transferee is going to have to pay for transfor's unrealized appreciation when transferee later disposes of property
        iv. Justification
            a. Widespread TP non-compliance w/ Davis rule – Transferors were not reporting gain, so IRS was getting screwed b/c **Davis** rule didn't allow them to collect from transferor either
                i. Counter intuitive to transferor that they were being enriched having to give their property to ex-wife in divorce.
            b. Response to practicalities – If IRS couldn't get tax from transferor (due to non-compliance) they asked Congress to at least grant deferral so could tax the appreciation later
3. **Davis & Farid** still good law?
    a. **Davis** – still stands for rule that any transfer of property in exchange for settlement of legal liability is a realization event.
        i. **§1041** just makes a carve-out for divorce settlements
    b. **Farid** – still come out the same way b/c Farid transfer took place in advanced settlement pre-nuptial K entered before marriage
        i. **§1041** only grants non-recognition in transfers that take place AFTER marriage.
4. Divorce property settlement planning issues
    a. **§1041** only applies to transfer's after marriage, not advanced settlement agreements b/f marriage (which is what **Farid** did) → make sure pre-nuptial K provides for transfer of property AFTER the marriage ceremony
    b. Since transferee is going to realize gain or loss at later date → need to make sure pty that gets the property that has declined in value is the pty that will have capital gains to offset the capital loss deduction at later disposition.

B. Tax Treatment of Spousal Support (i.e, Alimony)

1. Judicial Treatment
    a. Payor - Not deductible
    b. Payee - Excludable
    c. Justification – treated as tax free damages for in kind support (**Raytheon**)
    d. Note – very favorable for TPs b/c payee usually one w/ lowest tax bracket
2. Initial Statutory treatment ('42 – '84)
    a. Payor – Deductible (**§215**)
    b. Payee – Must be included in GI (**§71(a)**)

c. Justification – When income tax changed from only taxing the wealthy, to taxing everybody, alimony payments made up huge part of TP's aftertax income → seen as crushing
d. Problem w/ this standard (as evidenced by **Bernatschke**)
    i. Alimony defined as periodic payments made in satisfaction of marital obligation to support wife.
    ii. Using that def., it was difficult to determine if periodic payments to ex-wife under annuity K that ex-husband purchased on divorce were alimony payments (taxable to payee) or scrambled property settlement transaction (tax free to payee)
        a. Ct's had to look at intent of parties and state law

3. Current Statutory treatment to resolve problem w/ old statutes
    a. Tax treatment same
        i. Payor – Deductible (**§215**)
        ii. Payee **–** Must be included in GI (**§71(a)**)
    b. **§71(b)(1)** Revised def. of alimony payment – brighltine, objective criteria that fixes subjective inquiry **Bernatschke** ct. had to go through
        i. Must be payment in cash
        ii. Received under a divorce or separation agreement
        iii. 3 other technical criteria must be met
    c. New problem w/ brightline, objective criteria – permits TP's to use tax planning to select most advantageous tax consequences w/out changing the substance of the transaction
        i. Violates **Old Colony** substance over form
        ii. But Congress is willing to accept this for administrative convenience sake.
    d. Tax Planning message
        i. If want alimony to be deductible to payor and includable by payee, just provide for cash payments in divorce agreement (**§71**)
            a. Very similar to tax treatment under **§1041**
        ii. If want alimony to be nondectible by payor and excludable by payee, just provide for in-kind payments or scrambled transaction (Damages for marital support under **Raytheon** default rule)
    e. **§71(f)** Alimony "recapture" rule
        i. If alimony payments don't last at least 3 yrs, then in 3d yr. payee gets big deduction to offset prior erroneous inclusion and payor has to make big tax payment to offset prior erroneous deductions.
        ii. This is Congress's attempt to distinguish b/t the potential planning abuse above by disallowing alimony treatment to cash payments that occurred in lump sum or over brief period of time
            a. But still easy to get around this by structuring alimony payment to last at least 3 yrs.

C. Tax Treatment of Child Support

1. Generally
    a. Child support is cash payments to former spouse over period of many years.

b. Looks identical to alimony payments under **§71(b)(1)** formalistic defitinition – but is it treated the same? No!

2. Statutory tax treatment is just the opposite of alimony
   a. **§71(c)** – Alimony rules shall not apply to payments of child support.
   b. Since alimony rules no longer apply, revert back to default rules
      i. Payor – Not deductible (no deduction unless express statute that allows deduction and none here)
         a. Exception - **§§ 151(a),(c); 152(e) –** If child is in custody of payor parent more than ½ the year, payor can get personal exemption deduction (unless ptys agree otherwise).
            i. What is a personal exemption deduction under 152(a), (c)?
      ii. Payee – Excluded (**Raytheon**)
      iii. Is this the right authority???
3. How to distinguish b/t alimony and child support – important b/c they get opposite tax treatment
   a. **(c)(1)** Terms of divorce state that the payments are for child support
   b. **(c)(2)** Payments fit formalistic def. of alimony but are fixed on a contingent related to a child (e.g, stop when child turns 18, gets married, etc).

<u>DEDUCTIONS (Cost of Producing Income)</u>

I. Deductions Generally

A. Main theme of tax policy

1. Apportion burden of supporting gov't fairly among every individual bases on that individual's resources available for consumption or saving
   a. CONSUMPTION IS CORE OF THE TAX BASE
2. To do this we can only tax on net income b/c only enriched from gross income less cost of producing that income

B. Purpose of deductions – Try to come up w/ tax equivalent of net income formula

1. All deductions serve this purpose
   a. **§162, 212** are the biggest
   b. **§167** depreciation deduction also big part
2. Formula: 2 formulas that state same thing
   a. Net income = gross income – expense of production
      i. Expense of production = immediate cost (**§§162, 212**) + depreciation (**§167**)
   b. Net income = consumption +/- △Wealth
      i. Consumption = core of tax base → never deductible per **§262**
      ii. △ Wealth
         a. Positive changes = savings just converted from cash to in-kind (capital expenditures) → never deductible per **§263**
         b. Negative change could be due to 2 things
            i. Consumption → never deductible per **§262**
            ii. True disenrichment → loss deduction per **§165**

C. But deductions compete w/ specific disallowance provisions

1. **§262** No deduction allowed for personal, living, or family expenditures

2. **§263** No deduction allowed for expenditures to acquire or improve property (including intangible property like good will)
    a. Note – but these expenses will be included in TP's basis in the property and depreciation deductions, so get recovery later (tax deferral)

II. Business and Investment Expenses

A. §162(a) Grants **deduction for "all the ordinary and necessary expenses"** incurred during the year "**in carrying on any trade or business**."

1. **§212** which allows for deduction of expenses necessary to maintain income producing property is counter part to **§162(a)**,
2. This allows for an immediate deduct for cost
    a. Unlike **§167** that is a spread deduction for cost)
3. Defining these terms – distinguishing b/t true business expenses (deductible) and personal expenses (not deductible per **§262**) (**Welch v. Helvering** – Held TP repaying debts of previous employer was not deductible business expense)
    a. "Necessary" = appropriate and helpful
        i. This includes business entertainment
        ii. Justification of relaxed definition - Should respect judgment of businessman (IRS/courts not qualified second guess business judgment)
    b. "Ordinary" = Common in business world
        i. Justification
            a. **Need an objective standard**, not looking at what is ordinary for the indiv. taxpayer
            b. If used mere reputation as standard then bizarre expenses would be deductible (going to strip club), but new businesses would never qualify.
    c. "In carrying on" any trade/biz. = expense must be incurred while in conduct of employment and further ER's biz. interests (**Smith** – child care case below)
        i. Justification
            a. Plain language meaning which focuses on present tense of the phrase and statutory purpose
            b. Must be able to distinguish expense that directly advances business interests and expense that only puts TP in a position to carry on trade/biz.

III. Determining whether specific expenses are deductible business

A. **Welch** mode of analysis for all business expense deductions.

1. Is the expense for:
    a. **Maintaining** a trade or business/income producing property?
        i. Only if TP can prove this → deductible under **§162, 212**
    b. **Acquire or improving** a trade or business/income producing property
        i. Not deductible per **§263**
    c. **Personal of family benefit** (consumption)
        i. Not deductible per **§262**

2. In **Welch** TP failed to prove it was expense to **maintain** his business reputation so Ct. had to assume that it expense was for one of the other reasons
    a. Illustrates importance of TP proving purpose of expense, otherwise disallowance provision will prevail
3. Test for whether expense cost of maintaining or improving: If expense increases the income producing potential of the business or property = improvement = not deductible.

B. Cost of Education
1. Theoretically correct treatment of educational expenses
    a. This is the same mode of analysis as **Welch**
    b. Education could be for:
        i. **Maintaining** an existing income producing skill set (e.g. CLE)
            a. Deductible under **§162**
        ii. **Purchase** of a new skill set that will produce income in the future (e.g., professional degree)
            a. Not deductible per **§263,**
            b. But theoretically should be deductible under **§167** b/c its an expense for producing income over many years
        iii. **Entertainment or recreation** (e.g., pottery class at night)
            a. Not deductible per **§262**
2. Actual tax treatment
    a. Only education expense to maintain an existing income producing skill (option 1) are deductible – per **§162**
    b. But most education expense are incurred under option 2 (purchase of new skills)
        i. Not deductible under **§162** b/c its an expense for acquiring a business
            a. Reinforced in **Treas. Reg. §1.162-5** – Expenses necessary to meet the minimum educational requirements for a profession or to enter a new trade are not deductible
        ii. No depreciation deduction under **§167** b/c skills (human capital) are not "property" under common usage
    c. Outcome – most education expense are taxed same as consumption, even if purchased to produce income

C. Expenses for mixed motive – both business and personal
1. General approach – if mixed motives we use all or nothing primary purpose test (just like gifts under **Duberstein**)
    a. TP's subjective motive inferred from objective facts
    b. But sometimes too difficult to determine TP's subjective motives and must est. brighline rule based on most factually common subjective motives
        i. By focusing on most factually common motives, it minimizes overall unfairness
2. Cost of childcare
    a. Theoretically correct treatment – must look at TP's motive for having kids
        i. If decided to have kids after began career → expenses are foreseeable part of personal decision → non deductible consumption (**§262**)

ii. If had kids then decided to take a job → employment not possible unless pay for childcare → should be deductible biz. expense (**§167**)

b. Problem w/ theoretical treatment – too difficult to determine TP's subjective motive
   i. Need objective, brightline test
   ii. Should pick the most factually common scenario and tax accordingly to minimize overall unfairness
c. Actual tax treatment - brightline
   i. Not deductible under **§162** b/c not incurred "in carrying on" trade or biz (**Smith** – see definitions in section above)
      a. Counter arg. rejected by ct - "but for" the cost of childcare, TP would not be able to carry on her business. This is unlike other consumption expense (e.g., food) which every TP is going to incur
   ii. Outcome – brightline test is correct from policy standpoint b/c today most children are result of a personal decision (consumption)
      a. But in time **Smith** decided ('37) the opposite was true and decision was incorrect from policy standpoint

3. Commuting
   a. Theoretically correct approach
      i. If work location is fixed and TP's can choose where to live (whether close or far away from work) → person decision → not deductible consumption per **§262**
      ii. If home location is fixed, then commuting cost is determined by wherever can find a job → commuting becomes necessary to earn income → should be deductible biz. expense per **§162**
   b. Actual tax treatment – brightline
      i. Commuting treated as cost of choosing where to live → personal decision → not deductible consumption per **§262**
         a. This is the most factually common scenario b/c too difficult to decided TP by TP basis
      ii. What about carrying on business while commuting (e.g., talking on phone)?
         a. Still not deductible – "in carrying on" requires the deduction further the business interest, not merely occur contemporaneously w/ a consumption expense
4. Clothing
   a. Theoretically correct treatment – clothing required to carry on a business falls under plain lang. of biz. expense deduction (**§162**)
   b. Actual tax treatment – brightline objective test
      i. Deductible only if clothing can not be used outside trade/biz., e.g., uniforms
         a. This recognized plain language of **§162** deduction
      ii. Not deductible if clothes purchased for business use can also be used for personal use outside the business (**Pevsner**)
         a. Per **§262** deduction disallowance

        b. This recognizes that inclusion provisions control over deduction provisions that cover the same topics
5. Business Meals
    a. Theoretically correct treatment
        i. Meeting to eat the meals furthers business interests → should be deductible under **§162** "carrying on" trade or biz.
        ii. But the cost of the actual meal does not further biz. interest and is consumption → should not be deductible per **§262** unless:
            a. Purpose of meal is to build camaraderie → furthers biz. interest
            b. Demands of biz. require TP to each at disagreeable restaurant → constrained consumption
    b. Actual tax treatment – brightline, objective test
        i. Not deductible unless TP can offer objective proof to separate price of renting the meeting place (deductible biz. exp) from price of meal (not deductible consumption)
            a. But see exception under meals incurred during biz. travel
6. Business Travel
    a. Transportation expenses
        i. Theoretically correct tax treatment
            a. Traveling for business furthers interest of ER and not motivated by consumption → transportation ex. deductible per **§162**
            b. But if combine business trip w/ vacation → transportation for vacation portion of trip is consumption motive → not deductible per **§262**
        ii. Actual tax treatment – brighline, all or nothing
            a. Primary motive test – all or none part of the transportation expenses is deductible based on primary motivation for the trip.
                i. Look to all facts and circumstances to determine primary motive
                ii. Justification - When purchase 1 airplane ticket for business trip that also using as vacation, impossible to split the expense for the flight up based on what portion motivated by business and what portion travel
    b. Meals/Lodging
        i. Theoretically correct treatment
            a. Meals are core consumption → not deductible per **§262**
            b. But also duplicative/forced consumption b/c TP's could stay for free at home or pay less by eating at home
        ii. Actual tax treatment
            a. Deductible biz. expense per **§162(a)(2)** unless lavish or extravagant AND
            b. **§ 274(n)** – can't deduct more than 50% of the expense
            c. Justification – these rules embody the mixed benefit received from the expense
7. Business Entertainment
    a. Theoretically correct treatment

i. Entertainment is core consumption → not deductible per **§262**
ii. But also get some biz. purpose and forced consumption → that portion should be deductible under **§167**

b. Actual tax treatment
   i. **§274(a)(1)** Activities generally considered to be entertainment are not deductible
      a. This rule trumps all authorized deductions
   ii. Exceptions
      a. **Treas. Reg. §1.274-2(c)(3)** Allows deduction for entertainment directly related to "active conduct" of trade/biz.
         i. Allows for thing like dinners and ballgames but excludes gen'l building of good will activities
      b. **Treas. Reg. §1.274(d)** Allows deduction for entertainment directly proceeding or following a bona fide biz. discussion and is associated w/ biz. activity
         i. Terms are defined very liberally to include entertainment activities that occur in same day as business activities
         ii. Allows for some schmoozing like going to dinner and opera w/ spouses the same day as business meeting (building good will)

D. Attorney's fees and damages in lawsuits relating to business/income producing property
   1. Tax treatment of attorneys fees
      a. Origin of claim test: Attorney's fees in lawsuit to protect business/income producing property only deductible under **§ 162** (trade/biz) or **§212** (income producing property) if claim arose over the business/property
         i. Not deductible just because consequences of lawsuit could hurt the business/property (**Gilmore** – atty fees for divorce not deductible just b/c adverse judgment could bankrupt TP's company)
      b. Implicit "carrying on" requirement read into **§212** just like **§162**
         i. TP must be "carrying on" his business/property when atty fees incurred
         ii. Justification of ignoring plain lang. of **§212** and reading in "carrying on" requirement
            a. Horizontal equity - **§§162, 212** meant to deduct same kind of expenses (cost of producing income)
               i. Can't treat a TP diff. just b/c income comes from property rather than business
            b. Economic neutrality – giving **§212** a more relaxed application would encourage TP's to produce income via property rather than a trade/biz.
   2. Tax treatment of damages paid
      a. Same analysis – did the lawsuit which gave rise to the damages occur while "carrying on" a biz/property?
         i. If so → deductible (e.g., car accident while driving to business meeting)

ii. If not → not deductible (e.g., car accident while street racing (consumption))

IV. Depreciation Deduction

A. §167(a) Grants **deduction for "reasonable wear and tear of property"**

1. The property must be one of 2 types
   a. Used in trade or business
   b. Held for the production of income
2. This allows for a ROC spread over useful life of the property
   a. contrast to other ways to get ROC
3. Justification for only allowing depreciation deduction for income producing property
   a. Must get an accurate measure of ANNUAL disenrichment per **§441**
   b. Depreciation on non-income producing property (e.g., house) is due to consumption → non deductible per **§262**
   c. Thus if allowed for depreciation deduction on personal property, it would in effect be allowing a consumption deduction

B. 3 ways to get ROC

1. **§167** – If property wears out over useful income producing life
   a. ROC spread over time
   b. Examples of depreciable property
      i. Buildings, machinery, annuities
      ii. **§197** – most intangible assets – e.g, purchased goodwill, customer lists, trade names, patents, copyrights
   c. Examples of non-depreciable property
      i. If its not used to produce income
      ii. Even if is used for income but doesn't wear out – e.g., land, contracts, stock, bond
2. **§1001(a)** – Adjusted basis (cost) offset at disposition for all property
   a. ROC last
3. **§165(c)** – Loss deduction on disposition of income producing property
   a. ROC last
4. Or all 3 via **§1016(a)**
   a. **(1)**Non-deductible capital expenses increase adjusted basis in property
   b. **(2)**Depreciation deductions reduce adjusted basis in the property
5. Point – if **§262, §263** disallows a deduction, will still get ROC for that expense, but just not until disposition
   a. It' all a matter of timing.

C. Mixed motive expenses

1. What if property is income producing property (eligible for depreciation deduction per **§167**) but also used to build new assets (expenses not deductible per **§263**)
   a. Rule: If property wears out building a long lived assets, then no depreciation deduction but instead added to the basis of the asset the property was used to build (**Idaho Power** – Trucks used to build power plant were not eligible for depreciation deduction but cost of depreciation added to basis of power plant).

i. Justification
    a. **§441** annual accounting requirement – The depreciation was not a cost of producing income for that taxable year, but for future years
    b. Deduction disallowance provisions control over deduction allowance provisions
    c. Horizontal equity, Economic neutrality – TP's who self construct assets would be given beneficial tax treatment.