**General:**

* Difference between stocks and bonds?
  + One word to mark the difference: Risk
    - Stock (equity) signifies ownership in a company
    - bond (debt) is a loan to issuer
* Depreciation?
  + wear and tear over time – loss of income-producing capacity of capital goods
    - e.g., machinery, plant, equipment, etc.
      * if taxing on net income basis, then need to take this into account
* Tax expenditure?
  + indirect gov’t spending through the use of tax preferences (deductions, credits, deferrel, etc.) – indirect form of gov’t spending
    - gov’t purposely not taxing X
    - by using a tax preference, instead of taking your money, it is kept
    - instead of writing check to X, the gov’t lets X deduct it from tax he owes
* Implicit tax?
  + costs, such as lower rates of return or higher prices, borne by participants in untaxed or favorably taxed markets
    - e.g., state and local bonds – due to non-tax nature of them, there is an implicit tax
* Imputed income?
  + income not received in monetary form and thus not typically subject to taxation
    - side transaction or transaction with yourself
      * e.g., unpaid housework
      * when you mow your own lawn, it should be taxed in theory
        + there’s an economic benefit that comes from mowing your own lawn
      * has gender equality / inequality issues through the tax code….address later

**Movie on 1986 Tax Act:**

Unique Bipartisan Support:

GOP – slashed marginal rates

DEM – broadened the tax base by closing loopholes for corporations

“Revenue Neutral” – enough broadening of base by closing corporate loopholes to make up for the decrease of tax rates

**Theoretical Issues / “Ideal” base**

Why do we have a tax on income?

economic power as a proxy for ability to pay

Do we have a pure, H-S economic income tax?

no

What are some of the fundamental deviations from H-S?

- the treatment of carve-outs

- the FUNDAMENTAL deviation: distinction between realized and unrealized gains – if true H-S system, then we should tax on a mark-to-market

-we don’t do this b/c: may create a disincentive to save

- imputed income

- we don’t do this b/c: administrability issue

- treatment of gifts

- we don’t do this b/c: policy – don’t want to tax intra-family giving

- employer provided fringe benefits

- we don’t do this b/c: hard to define

- income on state/local bonds

- we don’t do this b/c: assist state and local gov’t in raising capital

We have an income tax: income = consumption + savings

-what would a Consumption tax look like?

Consumption = Income – Savings

- we do this sometime:

- IRA / college saving plans – can deduct savings to certain accounts

- We actually have a hybrid income tax system b/c we have all these carve outs:

- 401K employer provided retirement accounts – money is subtracted from taxable income

- Benefits of taxing only consumption ?

-Simplicity – if we had a consumption tax based on sales tax, then much simpler

- It would encourage savings – income tax system kind of double taxes savings b/c your taxed on the income, then you’re taxed again on the interest in your savings

- Drawbacks of taxing only consumption ?

- can be highly Regressive:

- lower income people have to devote larger percentages of income to consumption are going to pay a much higher percentage of tax

- Examples of Consumption Tax?

- Retail Sales Tax

- Value-Added Tax (VAT)

- ex: each stage in the making of bread, someone is adding value – they would be taxed on that portion of value added

Why the commitment to progressivity?

- Commitment “ability to pay” based on economic status

- diminishing marginal utility:

- each extra dollar brings less happiness than the last dollar

- the last dollar is valued less by a wealthy person than a poor person

- Revenue

- you raise a lot more money

- address concentrations of wealth

- egalitarian – even out distribution of income

- economic stagnation

**Policy of Tax Law**

1.) Equity:

Vertical – someone who makes much less money should pay less (e.g., marginal tax rates)

Horizontal – two people making roughly same income should pay similar tax

2.) Efficiency: Taxes Distort behavior; encourages people to act in ways otherwise not socially optimal (e.g., imputed income)

3.) Administrability: is it plausible to enforce?

Principle Goals of Taxation

(A) Providing Revenue for Public Goods (e.g., roads, bridges, education, social insurance, national defense, etc.)

(B) Distributing the costs of government “fairly”

- Horizontal and Vertical equity

- “Distributive Justice” – redistribution of wealth

(C) Economic Goals – managing macro-economic business cycles; promoting economic growth/efficiency

(D) Influence Certain Taxpayer Behavior (e.g., tax credits for electric cars)

Basic Tax Terminology

Gross Income (**Code Section 61)**: All income from whatever source derived – broad and expansive definition

Adjusted Gross Income (AGI) (**Code Section 62**)

AGI = Gross Income minus Above the Line Deductions

- AGI gets at Net Income – Above the Line Deductions include trade or business expenses and other income producing costs.

Taxable Income (**Code Section 63, 67 – Miscellaneous Itemized Deductions**)

AGI minus itemized deductions/standard deduction (below the line deductions)

**Section 63(b)**: For those who do not itemize their deductions, taxable income is derived from AGI minus (1) the standard deduction and (2) the deduction for personal exemptions (i.e., dependents)

- Why? Fairness – if you have kids, you can’t pas much as ppl w/out kids

This gives the taxpayer a choice, The taxpayer can use the standardized deduction or the itemized deduction, depending on which is greater.

**Section 67: 2% Floor on Miscellaneous Itemized Deductions**

Only applies to individual, not business entities

Only allows itemizing (rather than taking the standard deduction) to the extent that miscellaneous itemized deductions exceed 2% of AGI

**Section 67(b): Defines Miscellaneous Itemized Deductions**

Excludes certain deductions from the MID calculation including home mortgage interest deduction, payment of taxes (usually property taxes) deduction, others

Calculating Tax Liability

Gross Income – Above the Line Deductions = AGI.

AGI – Below the Line Deductions = Taxable Income

Taxable Income \* Tax Rate = Tax Liability

Tax Liability – Tax Credits

Importance of Above the Line vs. Below the Line Deductions

Below the line deductions are contingent upon the 2% AGI floor in **Section 67** and the comparison of itemized deductions to the standard deduction

Preference for above the line deductions

Standard deduction is an administrative out for people with more simple asset structures (don’t make people bother itemizing if their deductions are going to be too little)

The personal exemption acknowledges that there is some level of subsistence where we don’t want to tax at all

Progressive Marginal Rates

Marginal tax rate = your top tax bracket rate

Effective Tax Rate: Total Tax Liability/Total Taxable Income

Deductions v. Credits

Deductions are made in calculating income and the marginal tax rate is applied to it.

A deduction of $1000 at a 28% marginal rate will realize a reduction in tax liability of $280

A credit is a deduction made to the actual tax liability

A credit of $1000 at a 28% marginal rate will realize a reduction in tax liability of $1000 (a dollar-for-dollar reduction in tax liability)

All else being equal, taxpayers prefer credits to deductions

Haig-Simons Definition of Income

Income = Consumption + Accumulation (over a specific period of time)

Consumption = What you consume (market value of consumption)

Accumulation = Change in wealth/savings (change in value of the store of property rights between two points in time

H-S Definition of Income: Income is the money value of the net accretion to one’s **economic power** between two points in time.

Time Value of Money

* A dollar today is worth more than a dollar tomorrow
* Conversely, a debt owed tomorrow is lower than the same debt owed today.

Implicates the opportunity cost of time

Today’s dollar can be invested immediately to earn interest (interest = price you pay to lend out money)

In the tax context, we would like to defer gains until a later date (and conversely, to accelerate losses to today) so we can defer tax liability (and accelerate tax deductions)

Deadweight Loss

We don’t want to distort behavior in the tax system. Deadweight loss is social/economic waste. As an example, if an airplane would fly regardless of whether people were sitting in empty seats, it is economically inefficient to fill those seats for free and it would result in adverse consequences to tax on this free flight. (Such consequences might consist of people being more likely to drive, or not taking the flight at all). This is social/economic waste.

**In-Kind Income/Noncash Benefits**

Anything of value other than cash received by a taxpayer. Usual context involves an employee who receives a good/service of value in lieu of a wage/salary; e.g., gum for babysitting

Includes meals for wait staff, free parking for employees, use of a company car, etc.

- in-kind income/noncash benefits are an ex of substance trumping form:

- in-kind/noncash in form, but substance is that there’s an economic benefit

Economics:

An employee at a 35% tax bracket would prefer a $66 desirable tax-free fringe benefit over $100 or ordinary cash compensation (after-tax value = $65)

An employer may prefer the $100 of extra compensation for tax purposes, but, the employer can likely provide the benefit for less than the $66 value and can also negotiate with the employee for a lower wage because of the tax free benefit

**Meals and Lodging**

**Benaglia v. Commissioner**: Man manages two hotels in Hawaii. Hotel provides he and his wife free rent and meals on the premises of one of the hotels. IRS says that these benefits (rent and food) are income and should be taxed. Taxpayer argues that that living and eating at the hotel are not benefits, but rather, they are requirements of the job that necessitate taxpayer being at the hotel at all hours of the day.

Holding: Even though the meals and lodging relieved the taxpayer of an expense which he would otherwise bear, they were not intended as compensation, but rather **were provided for the convenience of the employer.**

Dissent focuses on monetary benefits in addition to convenience of employer

Policy angle focuses on whether the in-kind income is additional compensation (and will thus be includable in income) vs. forced personal consumption that is essential for the employee’s performance of his/her job and done for the benefit of the employer (in which case it would be excludable)

**Section 119 (Meals or Lodging Furnished for the Convenience of the Employer)**

There shall be **excluded** from gross income of an employee the value of any meals or lodging **furnished to him**, his spouse, or any of his dependents by or on behalf of his employer **for the convenience of the employer**

1.) Meals must be furnished on the premises of employer

2.) Lodging requirement must be a condition of employment

3.) The meal/lodging must be furnished to employee. It can’t be money given to employee for purpose of food/lodging

**Employer-Provided Fringe Benefits**

Problems with taxing employer-provided fringe benefits:

- Valuation, Liquidity, Enforcement, and Political Acceptance

- Economic Efficiency sometimes (e.g., free flights – each additional passenger decreases overhead; potentially no cost to airline; economically inefficient to not allow it)

**Section 132**

Gross income shall not include any fringe benefit which qualifies as a:

**(B)** No additional cost service (ex. airline giving free airfare to employees on undersold flights – efficiency concern, valuation problems, politicking)

**(C)** Qualified employee discount (ex. modest discounts on sale items for employees)

**(D)** Working condition fringe (Q is: could Ee deduct as business expense under §162 if he was a solo practitioner?)

**(E)** De minimis fringe (look at **Treas. Reg. 1.132-6(c), (d), (e)**

1.132-6(c) – Frequency of gift?

1.132-6(e) – small in comparison to salary?

**(F)** Qualified transportation fringe (ex. employer provided parking, mass transit passes

**(G)** Qualified moving expense reimbursement

**(M)**Qualified retirement planning services

**(J)** Special Rules

**(J)(4)** Gross income shall not include the value of any on- premises athletic facility provided by an employer to his employees

**Non-Discrimination Provision (Treas. Reg. 1.132-8)**

- if employer-provided benefit under “no-additional cost” or “qualified employee discount,” then Employer must provide to all employees

**Cafeteria Plans**

Program that allows an employee to choose among a variety of noncash nontaxable fringe benefits or taxable cash

**Section 125:** Except as provided in subsection (b), no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan

In absence of Section 125, constructive receipt would govern and taxpayer would be taxed on cash that he/she could have taken regardless of whether he/she took cash or benefit

**Use-it-or-lose-it Rule (125(d)(2)(A)):** For any noncash nontaxable fringe benefit that a taxpayer elects to receive at the beginning of a tax year, any unused part of that benefit at the end of the year will be lost to the taxpayer, unless a change in election of benefits occurs as a result of a change in family status

**Frequent Flier Credits**

Implicates mixed motives where a taxpayer takes a flight for business purposes but utilizes the frequent flier credits for personal consumption (this seems like income).

IRS threw in the towel, issued an announcement in 2002 saying that it would not enforce frequent flier credits

This was too administratively difficult for the IRS to monitor. It also implicated notion that the frequent fliers it would punish are the people who make the laws (i.e., Congressmen fly on gov’t dime to/from DC).

**Non-Employer In-Kind Benefits (Other Fringe Benefits)**

**Haverly v. US (1975)**: Principal of school receives unsolicited free books and excludes them from income. Later, he donates those *books* to the library and tries to take a charitable contribution deduction

He is trying to double dip (exclusion + deduction)

**Revenue Ruling 70-498:** Requires book reviewers to include in gross income the FMV of unsolicited sample books

**Employer-Provided Health Insurance (Fairness)**

**-** Under **Section 106(a)**, health insurance benefits received by employees are excludable from gross income

- There is a similar health insurance tax benefit for people who are self-employed **(Section 162(l))**, which is fair to the self-employed; BUT

**-** If you are an employee of an employer that doesn’t provide health insurance, your health care benefits are taxable. **Section 213** does allow an exclusion for personal health expenses but there is a floor to clear of 7.5% of AGI (a very high barrier)

Who benefits and who suffers?

- Employees benefit from having less taxable income. Insurance companies and third parties benefit from the business buy-in. Employers benefit because they can ask for a wage concession in return for health insurance

- Taxpayers suffer b/c gov’t collects less taxes

- Ees who don’t receive Er-provided benefits

**Alternative Valuation**

**Turner v. Commissioner:** Turner randomly selected by a radio station to answer questions to win steamboat ticket to S America. Upon winning, he negotiates the transfer of 2 first-class tickets into 4 tickets. He claims $520 as the value of the tickets for his tax return. Commissioner claims retail price at $2,220. Court concludes the value to be $1,400, splitting the difference. **Court gives credence to the subjective value of the taxpayer**. The taxpayer didn’t really have the means to pay $2,220 for the tickets and he would not have bought them had he not won the radio promotion.

**Policy Rationales for Fringe Benefits (Generally)**

**-** Saves on enforcement/administrative costs.

- It doesn’t cost the IRS as much to enforce compliance

- It doesn’t implicate difficult questions of valuation

- There is greater legitimacy for enforcement outside of these exclusions. Clear line drawn.

**Imputed Income**

Income not received in monetary form and thus, not typically subject to taxation because it is an implicit transaction with oneself providing a benefit otherwise attainable only through a paid market

- think of tax payer as schizophrenic – he’s both client and seller/proprietor

**Key Part:** Absence of observable market transaction between two parties

- Examples include: self-provided home-making/child care, self-provided tax preparation, do-it yourself maintenance (painting, carpentry), creation of consumer durables (owner-occupied housing), cutting your own hair

- Implicates opportunity costs

Creates Economic Waste: James’ makes $20/hr on wknds (adds $20/hr to society); Diane charges $14/hr to paint houses ($14/hr). If James is in 35% tax bracket, he will paint his own house on wknd instead of working b/c he makes $13 after taxes; if he worked and paid Diane, he would lose $1/hr. Society loses out on $6 per hour b/c James paints house instead of working.

Solution: (1) let James deduct cost of paying someone else to do it

(2) Tax James on his imputed income

**Services:** The effect of taxes on laborer’s decisions to perform services are noticeable.

A worker who makes $20/hr and who has the option of painting his own house or hiring someone to paint his house will have to think about the effects of tax rates, the value of his time, in making the decision.

Household Services & Impact

Creates disincentives for secondary earners to re-enter the workforce where the effect of income and taxes do not outweigh the costs of childcare

**Property:**

Imputed income of owning a home.

The right to use property has economic value and the right to use property without paying rent represents an economic benefit (unpaid rent is sometimes included in gross income)

Home Mortgage Interest Deduction

Encourages homeownership

Brings those people who buy homes on debt closer to those who buy homes with cash

Imputed Income of Leisure (What is your free time worth to you?)

**Windfalls and Gifts**

Windfall: example is catching homerun baseball

- go to Treas. Reg §1.61-14 – treasure trove – “to extent of its value in U.S. currency, it constitutes gross income for taxable year in which it is reduced to undisputed possession.”

- But IRS doesn’t go this far on homerun balls b/c of Valuation/Liquidity probs.

**Commissioner v. Glenshaw Glass Co. (1955)**

Glenshaw Glass was paid punitive damages as part of a settlement of an antitrust and fraud claim. The compensatory damages were clearly income. The issue in this case was whether punitive damages count as income. Supreme Court held that punitive damages do count as income.

Reasoning: Relevant Code Section (22 back then, 61 today) defines “income from whatever source derived. Justice Warren focuses on the fact that there have been **undeniable accessions to wealth**, **clearly realized**, and over which the **taxpayers have complete dominion.**

1.) Accessions to Wealth – This is classic Haig-Simons language

2.) Realization Requirement – This is not something like a stock dividend. It is clearly cash, has liquidity, has clearly been realized

3.) Complete Dominion – Taxpayers have complete choice over whether they actually consume money, invest it, etc.

\***Glenshaw Glass** partly overruled the reasoning in \***Eisner v. Macomber**, which defined income as, “the gain derived from capital, from labor, or from both combined.”

- **Macomber** Court focused on the sources of income (labor, capital, both). Punitive damages don’t fall neatly into either of these categories

- **Glenshaw Glass** Court focused on the uses to which income can be put

**Difference between a Windfall and a Gift**

There is no donative intent with respect to a windfall

**Tax Treatment of Gifts (Options and Policy Rationales)**

(1) **Donor Deduction and Donee Inclusion**

- Makes sense under the idea that the donee is the one benefitting and, thus, should pay taxes on the benefit

- Donors might make gifts to donees in lower tax brackets to reduce his/her liability. Donees generally pay less tax on the gift leading to revenue loss for IRS

- A donor does not likely want a donee to have to pay taxes on his/her gift

- Donors are magnanimous. A deduction ignores the consumptive value of giving

- Also, will have chilling effect on intra-family giving

(2) **No Donor Deduction and Donee Inclusion** – This is Double Taxation

- Also, will have chilling effect on intra-family giving

(3) **No Donor Deduction and Donee Exclusion (The Status Quo in US)**

-§102 permits the Donee to exlude gifts.

- Ignores intra-family transfers, encourages them so long as the gifts are made with after-tax dollars

- Treats family as single tax unit

- Donee gets untaxed income, but requires tax law to scrutinize transfers for intent

**Donor Deduction and Donee Exclusion** – Would be huge loophole in tax system

**Section 102 (Gifts and Inheritances)**

General Rule (**102(a)**) – Gross income does not include the value of property acquired by gift, bequest devise, or inheritance

Exclusions (**102(b)**) – Subsection (a) shall not exclude from gross income

1. The income from any property referred to in subsection (a) (If you give some a property (an apartment), the property is treated as a gift, but the rental income from that property is not treated as such.); or
2. Where the gift, bequest, devise, or inheritance is of income from property, the amount of such income (There are sophisticated financial ways to split income from a gift. These methods of splitting are not excludable)

- EX: Donee not taxed on stock transfers, but donee is taxed on dividends

**Commissioner v. Duberstein (1960)** – Intent of gift is key

Duberstein, as president of an iron and metal company had proven helpful in telephone consultations to Berman, who used those discussions to solicit customers. In recognition of the helpfulness of their discussion, Berman sought to give Duberstein a present (i.e., Cadillac).

Duberstein did not view it as compensation for services rendered. The issue is whether such business gifts are taxable.

Holding: At the end of the day, the Cadillac was still granted in recognition for services rendered. How Duberstein viewed the transfer is irrelevant. In this case, the donor’s intent is key and, in order to qualify as a gift under **Section 102**, requires **“detached and disinterested generosity”** on the part of the donor.

Frankfurter’s Concurrence: Frankfurter supports the government test that would effectively rule out gift transfers from employers to employees.

**Section 102(c)** **(Employee Gifts)**: Subsection (a) shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee.

Duberstein saw the **potential double-dipping problem**. In Duberstein, Duberstein received a Cadillac and tried to claim gift treatment; Berman gifted the Cadillac and claimed a business deduction. If allowed this would create a double tax benefit, which violates tax logic.

**Section 274** – statutorily eliminates the double-dipping problem

**274(a)**: No deduction otherwise allowable under this chapter shall be allowed for any item that constitutes entertainment, amusement, or recreation, unless we can establish nexus to business.

- This subsection tries to delineate the mixed motive of business and personal consumption

**274(b)**: No deduction shall be allowed under section 162 or section 212 for any expense for gifts made directly or indirectly to any individual to the extent that such expense when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25.

- if excluded by donee under §102, then Donor can’t deduct; or vise versa

- ex: Oprah’s car giveaway – Pontiac deducts cars as business marketing expense; SO, donees have to include b/c of §274(b)(i).

- 274(b) does exclude business cards, signs, display racks, promotional material

- 274(b) is considered a form of surrogate taxation. Ideally, the IRS should tax the recipient of a gift, under the Haig-Simons notion of income. But, we tax the donor by not allowing a deduction.

- ex: Small business owner invited to Ee’s wedding; gives large gift. Fast-specific analysis of who pays; but comes down to how Er treats it? If Er deducts it, then Ee has to include it (Matching Principle). There are potential valuation/liquidity problems with this though.

**US v. Harris**

Two women carried on relationships with Kritzik. He provided them w/ $500k. The issue is whether this is compensation that he paid for their company (payment for services rendered), or whether this constitutes a gift.

Court held that these payments were gifts and not taxable.

**Application of Gifts**

**Scholarships (Section 117 (Qualified Scholarships))**

**117(a) General Rule –** Gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in **Section 170(b)(1)(A)(ii)**

- Under **Section 170(b)(1)(A)(ii)**, an educational organization is one which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are carried on.

**117(b)(1)** – For purposes of this section, the term qualified scholarship means any amount received by an individual as a scholarship or fellowship grant to the extent that the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses.

**117(b)(2)** – Qualified tuition and related expenses means

- Tuition and fees required for enrollment or attendance; and

- Fees, books, supplies, and equipment required for courses of instruction at such an educational organization

**117(c)**: You can’t exclude any amount that you get in exchange for working/research/teaching/other services in connection with a scholarship. If we are going to adhere to matters of horizontal equity. We don’t want to treat scholarship recipients differently from those who don’t receive it. In addition, this generally looks like payment for services rendered. We would normally tax that.

**117(d) Qualified Tuition Reduction**: Gross income shall not include any qualified tuition reduction

- If I work at IU, and my son goes to IU and receives a reduction in tuition, that reduction is excludable.

**Tips**

- Under **Treas. Reg. 1.61-2(a)(1)**, ordinary tips are includible in income

- The problems of enforcement of tip taxation resulted in **Section 6053**, which required complex rules regarding employer information returns on actual or putative tip income

**Transfer of Unrealized Gain by Gift While the Donor is Still Alive**

**Section 1001, 1011, 1012, 1016 (Determination of Amount of AND Recognition of Gain or Loss – Calculating Basis)**

- Basis = value when property is acquired; it signifies your post-tax investment.

**- 1001(a):** The gain from the sale or other disposition of property shall be the **excess of the amount realized therefrom over the adjusted basis** provided in **Section - 1011** for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized

- **1012(a)**: In general, the basis of property shall be the cost of such property, except as otherwise provided

Amount Realized – Adjusted Basis = Gain from Sale

Adjusted Basis – Amount Realized = Loss from Sale

**1016 (Adjustments to Basis)** – tells us how to adjust basis

**1016(a)**: Proper adjustment in respect of the property shall be in all cases made:

**-** For expenditures, receipts, losses, or other items, properly chargeable to capital account (i.e., capital improvements to prop)

- For exhaustion, wear and tear, obsolescence, amortization, and depletion (depreciation deductions – reduction in capital improvements)

**-** Gain/Loss from Sale = Amount Realized (§1001(b)) minus Adjusted Basis (§1011)

**-** §1016 tells how to adjust basis:

**-** capital improvements to property

**-** depreciation deductions (reduction of capital improvements)

**Taft v. Bowers**

In 1916, A purchased 100 shares of stock for $1k. In 1923, the FMV of the stock was $2k. In 1923, A transferred his stock to B as a gift. In 1923, B sold stock for $5k

Issue: When this property was gifted, it had an embedded gain of $1k. But, it was sold for $5k.

Options:

(1) Gift could be treated as a realization event, creating $1k gain for donor, with donee taking FMV at time of transfer as basis. At eventual sale, she would be taxed on only $3k of gain

- BUT this violates our notion of gifting. We don’t consider gifts to be realization events

(2) Realization only occurs at final sale, and transfers the donor’s basis of the property to the donee. When she ultimately disposes of the asset, she is responsible for $4k of gain ($5k FMV - $1k initial/adjusted basis)

(3) Realization at sale, but allocate gain among donor and donee. But, this is too difficult to administrate

Holding: **Taxpayer/donee is responsible for the full gain**. By accepting the gift, the donee voluntarily assumed the position of the donor.

- If the court had not sided with the IRS, people would hold onto assets as long as they could and gift them at the last possible moment and avoid tax liability. This would undermine a great deal of tax liability.

- REMEMBER: No immediate tax b/c §102(a) gift; there is just a change in BASIS

- when doing an analysis, start with (1) no tax b/c gift per §102(a), THEN do the realization analysis.

**Section 1015 Basis of Property Acquired by Gifts and Transfers in Trust**

**1015(a)**: If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift **(This takes us straight to a Section 102/1011 analysis – basis for donee will be cost)**

**1015(a) (continued):** Except that, if such basis (adjusted for the period before the date of the gift as provided in Section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss, the basis shall be such fair market value **(If the basis is greater than FMW when the gift was given, then basis for determining loss shall just be the FMV)**

**- Double Standard:**

**-** Transfer **Basis** for **gains**

- **FMV** at transfer for **losses**

- Congress worried about abuse by transferring losses, BUT it created a hole, see Treas. Reg. §1.1015-1(a)

- ex: Property cost basis of $1,000. Prop transferred when FMV = $700.

- if property is sold for over $1K, then we use basis b/c gain

- if property is sold for under $700, then we use FMV at transfer b/c loss

- BUT what do we use if sold for an amount between $700 & $1K?

- When there’s no gain or loss, we have a hole.

**Section 267 (Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers)**

**267(a)(1)**: In general, no deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b).

**267(b)**: Defines Related Taxpayers for purposes of this Section

**Transfers at Death**

**Section 1014 (Basis of Property Acquired from a Decedent)**

**1014(a)**: Basis of a property acquired by an heir at the death of a decedent (and was not sold, exchanged, otherwise disposed of) shall be the fair market value of the property at the date of the decedent’s death.

**Stepped-Up Basis**: Heirs take property with FMV at date of death of decedent. Congress has essentially said that, when people inherit gained property, they can take the stepped-up basis of that property. This creates an immobility of capital, wealth concentration. It creates an incentive for decedents to lock in capital and pass it on to heirs.

Policy Rationale: This is administratively easier. FMV at time of death is easy to calculate. But, to go back generations to make basis calculation would be impractical.

BUT creates certain incentives:

- For gain property: hold on until death

- For loss property: realize/sell the loss property before dying

**Exceptions to §1014**:

**1014(c)**: Stepped-up basis does not apply to property which constitutes a right to receive an item of income in respect of a decedent under Section 691.

**1014(e)**: Stepped-up basis does not apply to appreciated property transferred to the donee upon death of decedent, but acquired by a decedent by gift in the year before decedent’s death. Stepped-up basis also does not apply to property that a donor grants to a decedent that reverts back to the donor upon decedent’s death.

- 1014(e) eliminates potential for abuse.

**Recovery of Capital**

**Inaja Land Co. v. Commissioner (1947)** – Sale of Easement = recovery of capital (decreases cost basis, which defers tax until property sold)

Man buys land for $61k. City of Los Angeles diverts water, messing up man’s land. He threatens to sue. The two parties settle for $50k. Court refers to it as an easement (the right to do something on someone else’s land)

Issue: Is the $50k settlement considered taxable income or a recovery of capital?

- Taxpayer says that it is non-taxable recovery of capital. He sold a bundle of rights

- Government argues that this is taxable income; compensation for loss of present and future ordinary income

Court decides for the taxpayer. Court claims that there is a problem of administrability. How is the loss of this property right valued numerically/monetarily? When you split a property like this, it is very difficult to administrate. The court held that the benefit is a recovery of capital. However, taxpayer’s cost basis is reduced. When he finally decides to sell the property, his realized gain will not be taken with respect to the $61k he paid, but rather, only $11k ($61k - $50k recovery of capital). This is a measure that defers his tax liability until later.

- *Inaja* = pro-TP b/c of time-value of money

**Recovery of Basis for Losses**

Where your realized amount is less than the adjusted basis, a taxpayer will incur a loss and only partially recover his/her basis

Depending on the use to which a taxpayer put an asset, a loss may be deductible

If the asset is used to produce income, the loss is generally deductible

If the asset is used for personal use, you may only deduct casualty losses under 165(c)

**Recovery of Capital – Life Insurance**

Insurance: way of pooling risk of a group of people

- also a form of wealth transfer 🡪 money moved from person paying premiums who never has fire to the person who does have fire 🡪 person who has fire wins

- Since TP uses after-tax dolalrs to pay premiums (i.e., premiums aren’t deductible), we don’t tax insurance payouts (i.e., exclusion under §101(a))

**Section 101(a) (Proceeds of Life Insurance Contracts Payable by Reason of Death):** Except as otherwise provided, gross income does not include amount received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured

**Section 101** is an exclusion to the beneficiary. The savings elements of a life insurance policy is generally excluded as well (for administrability reasons) even though these savings provisions are not encouraged

**Recovery of Capital – Annuities**

Annuity: Contract providing future payments in return for an up-front fixed sum

- Another way of pooling risk – not everyone is going to live that extra year

Tax Treatment of Annuities:

**Section 72(a)** **(General Rule):** Gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

**-** Intuitively, this does not make sense because some of the proceeds derived from an annuity should go towards a recovery of capital

- b/c TP used after-tax dollars to purchase the annuity

- 72(b) allows TP to deduct the portion that is recovery of capital

**Section 72(b) (Exclusion Ratio):** Gross income does not include that part of any amount received as an annuity, endowment or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity’s starting date) bears to the expected return under the contract (as of such date).

**The exclusion ratio is the investment/expected return.** The Amount received a part of an annuity payment that bears the same ratio as this investment/expected return is not gross income

- this is pro-TP b/c it ignores the time-value of money

-the RATIO: Investment of the Contract (initial basis): Annuity Payment (expected return)

(Initial Basis) / (Expected Return)

Ratio = (purchase price of annuity) / (total payout) =

- to find the taxable amount of an annuity, multiply the ratio by the payment; that is how much is excluded

- taxable amount = Payment minus Exclusion

**Gambling Gains/Losses**

**Section 165(d)**: You are only allowed to deduct gambling losses to the extent of gains. If I win a certain amount of money, then lose more money than I won, I can only deduct losses up to the amount that I won.

This is an example of “netting” or “basketing” in the tax law

- Prohibits net gambling losses from sheltering other income

- Moral value judgment against gambling

- Gambling is considered some form of personal consumption and shouldn’t be deductible (Haig-Simons: it’s entertainment / personal consumption)

**Non-Taxable Compensation for Loss**

**Clark v. Commissioner (1939)**

**-** Clark was advised by his tax consultant to file a joint return instead of filing separately. He was audited and found out that he could have saved by filing separately. His tax consultant paid him the money he would have saved from filing separately. Government wants to tax the compensation of loss.

- Government argues that this is income

- Clark argues that he is being compensated for a loss that impaired his capital

- Holding: This compensation is excluded. This payment was a compensation for a loss that impaired the taxpayer’s capital 🡪 recovery of capital (or recovery of basis)

- Taxpayer’s basis/baseline tax liability was unfairly changed/impaired by his tax adviser’s negligence. The adviser’s decision to give him the extra money was a recovery of that basis.

- Chirelstein treats this like a tax refund. We aren’t taxed on our tax refunds because the point of a tax refund is to give you back what taxes you paid extra. It also implicates the fact that this tax refund accrued in the previous year and is not taxable in the following year

**Annual Accounting and Its Consequences**

**Burnet v. Sanford and Brooks Co.**

There was a dredging contract between the government and a dredging company to dredge the Delaware River. The company incurred losses for the first few years, eventually abandoned the contract, and sued for breach of warranty. Company gains judgment of $175k to compensate for the expense, interest.

- Issue: What is the tax treatment of the “compensation” for losses?

- TP argues for transactional accounting

- IRS argues for fixed annual accounting (i.e., count it as income this year)

- Holding: Fixed annual accounting (i.e., the “compensation” for the expense was income this year) b/c transactional accounting would be an administrative nightmare.

- not a great argument b/c we look back all the time (e.g., income from sale of property).

**Accounting Year** – *Burnett* codified

**- Section 441 (Period for Computation of Taxable Income)**

**441(a):** Taxable Income shall be computed on the basis of the taxpayer’s taxable year

**441(b)**: Taxable year means taxpayer’s annual accounting period, the calendar year, etc.

**441(c)**: Annual Accounting Period Defined

**441(d)**: Calendar Year Defined

**441(e)**: Fiscal year Defined

- Companies that have wide disparity in income each year are screwed by unequal tax treatment 🡪 IRS solves this problem by permitting Net Operating Loss Deductions (NOLs)

**Mitigating the Rigidity of Annual Accounting**

**Section 172 (Net Operating Loss Deduction)**

**Section 172(a)**: There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year.

**Section 172(b)**: **General Rule** – A net operating loss for any taxable year

1. Shall be a net operating loss **carryback** to each of the 2 taxable years preceding the taxable year of such loss
2. Shall be a net operating loss **carryover** to each of the 20 taxable years following the taxable year of the loss

**-** Policy Rationales for Carryover/Carryback

- Fairness: Firms in more volatile industries that incur losses in most years but have one big year will not be adversely affected

- New ventures/business who incur losses in the first few years will see later gains offset. This encourages entrepreneurial ventures

- Cushions impact of business cycles - The volatility in the business cycle necessitates net operating loss carryovers

- NOL carryovers encourage risk taking

- More Frontloading (i.e., 20 yrs carryover vs. 2 yrs carryback) encourages long-term investments

**Section 460 (Percentage of Completion Method for Long-Term Contracts):** Provides that, for taxpayers who perform long-term contracts for construction or manufacture of property, must account for profit under the “percentage-of-completion method.”

**Claim of Right**

**North American Oil Consolidated v. Burnet (1932)**

North American Oil drilled on land owned by the United States. US kicked them off the land. Taxpayer received money with the chance of losing it later. North American Oil earned funds in 1916. In 1917, North American Oil was paid, and in 1918, North American Oil filed an amended tax return to account for those funds received. North American Oil wanted those funds to be recorded as received in 1916 (when earnings were accrued) as opposed to 1917, when funds were actually received. This case is litigated because taxpayer wanted to take advantage of the differential tax rates between years.

Holding: If a taxpayer **receives earnings under a claim of right** and **without restriction as to its disposition**, he has **received income** which he is required to report, **even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.**

**Potential Options for Claim of Right**

(1) Exclude income until all uncertainty is resolved. (In North American Oil, this would involve waiting until 1922 to discern the realization of income.) As a general rule, this isn’t very practical. It goes too far and leads to great taxpayer benefit (deferral).

- Undermines Haig-Simons notion of income

(2) Retrospectively determine which year the income was received. This creates a problem of closure for past years. We could be litigating far into the future for a year in the past.

(3) Use current information as “correctly” as possible. This would be the economically accurate approach. But, it is impractical b/c administrative nightmare.

(4) “Follow the Money.” This approach considers when the taxpayer was allowed to consume and save without restriction. This is practical and generally fair.

**United States v. Lewis (1951)**

Taxpayer was paid a $22k employment bonus in 1944. Two years later, his employer realized that Lewis had been overpaid and the bonus was reduced to $11k. Under claim of right analysis, even if he made a mistake of fact, taxpayer still owes taxes on this amount. He can claim a deduction in 1946, but this happens to be subject to a different tax rate.

**Congressional Response to Lewis, Claim of Right**

**Section 1341(a): General Rule:** If

1. Item was included in gross income in previous taxable year because it was held by taxpayer under a claim of right (and “unrestricted” right); AND
2. A deduction is allowable for the current year because you didn’t realize that the claim of right was false by the end of the previous taxable year (year you thought you had the claim of right); AND
3. The deduction exceeds $3,000; THEN the tax imposed will be the lesser of the following:
4. Tax for the taxable year computed with the deduction; OR
5. Tax for the current taxable year computed without the deduction minus the tax owed for the prior year not including the income from the claim of right.

Ex: Yr. 1, 35% tax bracket TP has claim of right to $20K income = 7K of tax.

Yr. 2, TP is in 25% bracket and must return entire funds.

- §1341(a)(4): TP deducts $20K per current tax bracket; only gets to deduct $5K.

- To make up for this disparity, §1341(a)(5) allows TP to deduct the old $7K he paid.

**Tax Benefit Rule**

**Dobson v. Commissioner**

**-** Taxpayer sells stock in year 1 at a loss, but cannot make use of the loss deduction. In year 2, the taxpayer determines that the lost stock was due to broker malfeasance and recovers the loss; he should be taxed on recovery.

- In a general sense of accessions to wealth, this should probably be taxable. But, taxpayer never benefitted from the loss deduction in the first place.

- Court Held: This recovery is excludable.

**Section 111 (Recovery of Tax Benefit Items)**

- Gross income does not include income that was recovered during the current taxable year from an amount in a prior taxable year that was deducted but did not reduce the amount of tax imposed (loss did no more than offset tax imposed)

**Alice Phelan Sullivan Corp. v. United States (1967)**

**-** Taxpayer made charitable gift of property subject to condition that property be used for either religious or educational purpose. Taxpayer claimed charitable deduction. 20 years later, charity decided not to use property, returned it to taxpayer.

- Holding: Recover generates taxable income in the amount of the earlier deduction, not in the amount/value in the year of its return.

- §111 does not NOT take into account potential for tax rate variation; TP gets no relief for tax rate variance. AND it won’t qualify for §1341 b/c 1341 is narrowly tailored to *Lewis* fact patterns where TP has included something in income w/ unrestricted rights that the TP has to subsequently give away.

**Hillsboro Bank v. Commissioner (1983)**

**-** Corporation was allowed, under **Section 164(e)**, to deduct certain state taxes that were imposed on shareholders, but that the corporation paid. There arose a state law dispute about the lawfulness of the tax. Tax payments were held in a state- administered escrow bund. Taxes were subsequently struck down. State repaid payments to shareholders, not the bank.

Commissioner argued that the bank had taxable income by reason of the refund, notwithstanding the fact that literal recovery had not actually been made (because the deduction was taken in reliance on a now-overturned state statute). Taxpayer argued that literal recovery was necessary in order for inclusion to be mandated.

- Court held for taxpayer, but not on literal recovery theory.

**Inclusionary vs. Exclusionary Tax Benefit Rule:**

- §111 is called the “exclusionary” aspect of the tax benefit rule b/c the unused deduction in the prior year allows for exclusion of recovery in later years.

- *Hillsboro* is called the “inclusionary” tax benefit rule b/c the “tax benefit rule will only ’cancel out’ an earlier deduction when . . . the later event is indeed fundamentally inconsistent w/ the premise on which the deduction was initially based.” Thus, the later income is not applied to unused deduction in the prior year if the income is fundamentally inconsistent with the prior deduction.

**Taxation of Tort Recoveries**

For non-individual taxpayers (corporation), damage awards for lost profits are taxed in the year they are received; and they are taxed.

**Section 104 (Compensation for Injuries or Sickness)**

1. With the exception of medical expenses under Section 213 (which allows deductions that exceed 7.5% of AGI – 104 excludes 213 deducts already taken to stop the potential double benefit taking both 213 deduct and 104 exclusion), gross income does not include (i.e., exclusion)
2. Amounts received as part of workmen’s compensation
3. Amounts of damages received in a settlement/lawsuit for personal injuries/physical injuries. **(This does not include punitive damages.)**
4. Amounts received through accident/health insurance for personal injuries or sickness
5. Amounts received as pension, annuity, or similar allowance for personal injuries/sickness resulting from active service in armed forces
6. Amounts received as disability income from injuries associated with terroristic/military action

- Could include: psychiatric bills, and loss of consortium (i.e., ability to have sexual relations), BUT need good lawyering

**-** Policy Rationale for 104:

- For normal damages in tort, we are simply trying to put someone back to where they were.

- There is no income – we’re just making person whole again.

- But it defeats the logic of §104 – i.e., bring ppl back ex-ante and make whole – if accident didn’t happen, then wages wouldn’t been taxed – doesn’t make intuitive sense that they aren’t taxed.

- Punitive damages are taxed b/c above and beyond and, thus, would be income under Haig-Simons.

- Horizontal Equity: fair compared to person who didn’t get injured in an accident; BUT unfair to a person who got injured in an accident but didn’t recover any tort damages

**Wage Replacement (Exclusion/Non-taxable)**

- Rationales for Exclusion:

- Opaqueness of Settlements: There is a valuation problem and a lack of transparency in settlements as to what amounts to lost wages and what does not

- Under-Compensation for Recovery: We don’t know the actual damage done to individuals. We don’t know if we are bringing them back to ex-ante status quo. We don’t know the potential future costs, so we don’t really want to tax

- Double Tax on Lump Sum Award:

- There is a notion that a lump sum up front is intended to represent your damages over time. There is a time value of money issue inherent in this

- In addition, tortfeasors aren’t allowed to take the deduction for the damages that they owe. Therefore, those wronged should be able to exclude (Gift Treatment).

**Murphy v. US (2006)**

Murphy recovered damages of $70k ($45k for emotional distress and mental anguish, $25k for injury to professional reputation). Government argued that Murphy’s recovery was not excludable (statute limits exclusion to physical injuries/physical sickness)

Justice Ginsburg argued that statute was unconstitutional under 16th amendment – 104(a)(2) allows taxation of punitive damages; where that tax is for lost wages, it is unconstitutional under the 16th amendment.

- BUT it was VACATED the same year.

**Cancellation of Debt Income**

**Anatomy of a Loan: A Loan is not income**

Borrower: Lender:

- Proceeds from loan – Not Income - Loan – not deductible

- Repayment of loan – Not deductible - Repayment of loan – not income

- **Interest on loan – May be deductible** - Interest on loan – taxable income

- Loan increases assets and liabilities

- Rationale: If you receive a loan, you receive the money/property involved, but you have the corresponding obligation to give it back, so you haven’t gained anything.

**-** Recourse Loans – Loans on which the borrower is personally liable

- Nonrecourse Loans – Loans on which the lender’s only recourse in case of default is against the property pledged as security for the loan

**US v. Kirby Lumber** – Cancellation of Debt (COD) Income

**-** Kirby Lumber issues bonds for $1 M apiece. It later buys back its own bonds for $862k (discount of $138k) because it is a better deal for them to buy back the bonds than to worry about paying back $1 M.

- Issue: Should the discharge of this debt be considered income?

- Holding: This is an increase in net worth. Taxpayer has realized an accession of income within the year. Kirby Lumber is codified in **Section 61(a)(12)**

- TP is better off and we can exactly quantify how much better off ($138K)

- IS this good Policy?

- No – generally when we see debt cancelled, the TP is in a bad financial position

- AND potential liquidity problem: the TP may not have the cash for the tax.

**Exceptions to COD Income**

**Insolvency of Debtor (Section 108(a)(1), (b), Section 1017)**

**Section 108(a)(1):** Gross income does not include any amount that would be includible in gross income under **61(a)(12)** if:

1. Discharge occurs as part of a bankruptcy case
2. Discharge occurs when taxpayer is insolvent
3. Discharge of indebtedness is “qualified farm indebtedness”
4. Discharge is “qualified real property business indebtedness (real estate business indebtedness)
5. Discharge is “qualified principal residence indebtedness, which is discharged before 1/1/2013 (mortgage forgiveness for housing crisis re-financing needs)” (i.e., FORECLOSURES).

**Section 108(a)(2) (Coordination of Exclusion):** Exclusions take precedence in this order: Title 11 Bankruptcy, Insolvency, Qualified Farm Exclusion, Qualified Real Property Business Exclusion, Principal Residence Exclusion

**Section 108(a)(3) (Insolvency Exclusion Limited to Amount of Insolvency)**: Exclusion amount under insolvency cannot exceed the amount by which the taxpayer is insolvent.

**Section 108(b):** If you are insolvent, you must reduce your tax attributes. To the extent that you are insolvent, you will have to reduce other exclusions, deductions, etc. in order to match that insolvency. 108(b)(2)(A)-(G) provide the order in which you must reduce these tax attributes. (NOL, General Business Credit, Minimum Tax Credit, Capital Loss Carryovers, Basis Reduction, Passive Activity Loss/Credit Carryovers,

Foreign Tax Credit Carryovers.

- (i.e., gov’t takes way from other tax deductions/exclusions the TP has available.)

- Other reductions include Purchase Price Reduction (**108(e)(5)**), Student Loan Forgiveness (**108(f)(2)**), Mortgage Forgiveness (**108(a)(1)(E), 108(h)**)

**Exceptions to COD income – Problem**

Alan borrows $150K from Jen (not related); later, A is insolvent but has assets:

- (1) $100K cash; and (2) $40K biz equip. (A/B = $60K) => extent of insolvency?

- $140K (assets) - $150K (loan) = -$10K (extent of insolvency)

- J accepts $75K to cancel debt (she took $0.50 on the dollar); J discharged/cancelled 50% of A’s debt

- at first blush, A should have $75K of COD income to report; BUT how much of $75K of COD is excludable?

- under §108(a)(1)(B) – discharging occurring when A is insolvent

- under §108(a)(3) – insolvency exclusion limited to amount of insolvency – in the case of discharge to which paragraph (a)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the TP is insolvent

- so, $10K will be excluded; but $65K will be taxed as COD income pursuant to §61(a)(12)

- What’s A’s new A/B in equipment?

- Basis – TP wants more basis in property – b/c the higher the upfront basis you have, the most depreciation deductions you will have

- Congress says it’s going to take away some the Basis

- reduce the basis by $10K; now the A/B is $50K

- congress is clawing back the tax benefit of $10K by reducing basis by $10K

- so the exclusion is really just a tax DEFERRAL

- A/B is $50K pursuant to §108(b)(2)(E), §1017(b)(2)

**Child Support and Other Obligations**

- Should failure to make legally-required child-support payments lead to COD income?

- yes

- Is the “dead-beat” parent better off than a similarly-situated TP who honors his debts

horizontal equity – TP is better off

**Transfers of Property Subject to Debt**

**Section 167(a)** provides depreciation deductions for the decreasing value of property from exhaustion, wear and tear, etc. in the context of trade or business or income production

Calculating the Amount of a Depreciation Deduction (Straight-Line Method)

(Cost – Salvage Value)/Useful Life

Policy?

- We have a Net income tax – proper definition must allow for some depreciation of income-producing assets

- Also, creates an economic incentive to induce investment in assets.

**Crane v. Commissioner (1947)**

**-** In 1932, a taxpayer inherited a property with FMV of $250k subject to nonrecourse debt of $250k. Between 1932 and 1938, taxpayer took depreciation deductions of $30k. In 1938, taxpayer sold the property for $2,500 cash. The property is still subject to the debt.

- Issue: How do we treat the debt component of the property

- Crane argues that the true value of the property is in her equity, not in his debt. By taxpayer’s logic, at sale, amount realized is $2,500 with adjusted basis of 0. Realized gain is $2,500, and, even though it was wrong to take the depreciation deductions, this cannot be re-litigated because the Statute of Limitations has run.

- IRS argues that the property is the value of the asset, including the debt. IRS doesn’t quibble with taxpayer’s depreciation deductions of $30k. But, the IRS argues that her original basis was $250k (the value of the mortgage) and that the adjusted basis is the value of the mortgage minus the depreciation deductions (250k – 30k = 220k). Thus, her amount realized is $252,500 ($2,500 cash receipt + $250k mortgage) and her Realized Gain is $32,500 (Amount Realized ($252,500) minus Adjusted Basis($220,000)

- \*Holding: For IRS; property = value, not equity. Debt is included in basis and amount realized. IRS holding is supported by statutory authority (**Section 1014, Section 1016, and Section 1001**) (statutes defining “property” as value, not equity).

- Administrability Corollary: If we were to rule in favor of taxpayer, we would have to calculate a depreciation deduction with equity as basis. In this case, we would have to keep track of equity. For every payment you make, you gain more equity. But, this would be very fluid and difficult to manage. It would be a huge hassle to continually calculate basis based on new equity payments.

- Crane stands for the appearance of symmetry and transactional consistency.

- IRS won battle, but may have lost the war:

- *Crane* allows you to front-load depreciation deductions for the sake of later recapture. This is a taxpayer benefit because time value of money principles help out taxpayer in this case, thus, *Crane* allows tax deferral.

- In addition, capital gains are taxed at lower rates. In this sense, Crane may have fueled tax shelters by allowing for inflated depreciable basis and avoidance of recapture

- Advantages of Non-Recourse Debt:

(1) limited buyer economic risk – lender bears risk that prop will drop in value

(2) allowed for inflated depreciable basis – if risk is limited, why not take on massive loan and use the depreciation value

(3) TP can possibly avoid “recapture” when FMV < debt (see *tufts*)

- Crane doesn’t answer the problem that arises in situations where FMV of property is less than the debt owed on that property – *Tufts* does.

**Commissioner v. Tufts (1983)**

In 1970, taxpayer builds apartments with $1.85 M in nonrecourse debt. Between 1970 and 1972, taxpayer claims depreciation deductions totaling $400k; resulting in an adjusted basis of $1.45 M. In 1972, taxpayer sells the apartments in exchange for assumption of debt. FMV of apartments is less than $1.4 M.

Issue: Does Crane apply in this case? Does the amount realized include the cancellation of debt, even when FMV is less than debt?

Taxpayer argues that this is a loss. The value of the property is less than the debt. He says that the extent of the liability was the FMV of the apartments. The benefit (amount realized) is less than $1.4 M (FMV of apts). The Adjusted Basis is $1.45 M.

Thus, this is a loss.

IRS: The benefit must equal the full amount of the debt, not the fair market value of the property. Thus, the amount realized would be 1.85 M, not 1.4 M 🡪 there is

an economic benefit of the full amount of debt that has been discharged. The Adjusted Basis is 1.45 M, resulting in a gain of 400k which is in symmetry with the

depreciation deductions that the TP took.

Court: Nonrecourse debt is included in the amount realized in its full unpaid amount. This is a matter of symmetry and transactional consistency.

- Symmetry: debt is treated consistently for Adjusted Basis and for Amount Realized.

O’Connor Concurrence: Argues that the transaction should be bifurcated into 20

transactions. The property transaction resulted in loss at sale of $50k (1.4 M (FMV/Amount Realized) – 1.45 M (Adjusted basis with depreciation deductions) = -.05 M). The loan transaction resulted in COD income of $400k (1.85 M (debt cancellation under **61(a)(12)**) – 1.45 M (Adjusted Basis with depreciation deductions) = $400k (taxable gain).

**Estate of Franklin (1976)**

Crane encouraged aggressive tax shelters, as in this case. This case involved a sale lease-back transaction. Taxpayer bought hotel with seller-financed, non-recourse debt that is far greater than the FMV of the hotel. Crane would indicate that we would just wait and take the depreciation deductions back later when the hotel was sold.

Court: Held that the debt lacked economic substance and was unlikely to be repaid. Debt NOT included in basis.

**Pleasant Summit Land Corp. (1988)**

Stands for the proposition that where third party non-recourse debt is greater than FMV of the property, it will be included in basis, but only to the extent of FMV. This proposition is premised on the fact that there was actually some expectation that the debt would be paid back.

Ex: TP uses $5K cash & $1M non-recourse debt to buy Resort w/ FMV of $400K. What is basis?

(1) *Crane*: $1,000,000 🡪 include full debt

(2) *Estate of Franklin*: $5,000 🡪 debt lacks economic substance

(3) *Pleasant Summit Land Corp*: $405,000 🡪 debt, but only up to FMV, and whatever cash was used

Congressional response to Tax Shelters: §465 & §469

- limits use of “passive activity” tax losses

- focuses on TP “material participation in the tax loss investment

**Interest on State and Local Bonds (Section 103)**

**Section 103(a)**: Except as provided in subsection (b), gross income does not include interest on any state or local bond

Putative tax – When tax-exempt bonds have lower interest than taxable bonds, the difference is a putative tax. Tax-exempt bonds will always have lower interest rates to substantiate their tax exempt status, but the actual rate difference is something that has to do with risk, marginal tax rates, etc. Putative tax of tax-exempt bonds are not realized by the federal government, but in the savings of state/local governments in issuing these bonds. The differences in marginal rates create some deadweight loss for tax exemption where the benefit only incurs for people in higher brackets. High bracket taxpayers will be more inclined to pursue bonds w/ lower interest rates in comparison to low bracket taxpayers because the progressivity of the system and inability of issuers to segment the market cause such alterations in taxpayer behavior.

**Exceptions/Limitations on Tax Exempt Status (Section 103(b))**

Exemption shall not apply to:

1. Private activity bond which is not a qualified bond within **Section 141.**
2. Any arbitrage bond within **Section 148.**
3. Any bond unless such bond meets requirements of **Section 149.**

Use of industrial revenue bonds (whose proceeds were used to finance private investment became so widespread that Congress eliminated tax exemptions for such bonds as “private activity bonds,” unless they fit within a specific “qualified” exception. Exception bonds include “exempt-facility bond” (**Section 142(a)**), qualified mortgage bonds, qualified small-issue bonds, etc.

Qualified private activity bonds are exempt under the regular tax but may be subject to AMT

Exceptions for private activity bonds are subject to

Purpose-related limitations

Quantitative/dollar-value caps

Tax Arbitrage

Borrowing at tax exempt rates and investing in taxable obligations expecting to profit on interest rate spread

**Gain on the Sale of a Home (Section 121)**

**Section 121(a)**: Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by taxpayer as the taxpayer’s **principal** residence of periods aggregating 2 years or more.

- Exclusion for gain/sale/exchange of property that has been principal residence of taxpayer for at least 2 of the last 5 years

- This creates a Congressional incentive for homeownership

- Lock-in Effect: If we don’t have this exclusion, people are not likely to sell their homes. They will feel locked into life in that home.

**Section 121(b): Limitations** (dollar value limits on exclusion)

**(b)(1):** The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange shall not exceed $250,000.

**(b)(2)(A)**: In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property, paragraph 1 will be applied by substituting $500,000 for $250,000, if certain conditions apply.

**(b)(3):** Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied)

**(b)(3)** indicates that the tax benefit will not be realized by home-flippers

**Section 121(c): Exclusions for Taxpayers Failing to Meet Certain Requirements**

**121(c)(1)**: In the case of a sale or exchange to which this subsection applies, the ownership and use requirements of subsection (a), and subsection (b)(3); shall not apply; but the dollar limitation under paragraph (1) or (2) of subsection (b), whichever is applicable, shall be equal **(Ownership and use requirements of subsection (a) will not apply in certain cases)**

**121(c)(1)(A)**: The dollar limitation (**250k for single filer, $500k for joint filers)** must equal the amount that bears the same ratio to such limitation as the shorter of:

**121(c)(1)(B)(i)(I):** Aggregate periods of ownership; or

**121(c)(1)(B)(i)(II)**: 2 years

**In a case where the owner sells property after 1 year with $250k of gain, the ratio is 1:2 (one year of ownership, two years of needed principal residence under the limitation). This ratio is multiplied by the realized gain ($250k\*1/2 = $125k = Exemption; $125k of the gain is taxable)**

**121(c)(2)(A), (B):** 121(c) applies to sales or exchanges that don’t fall under **121(a)** by reason of failure to meet ownership/use requirements, or if such sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances (provided for in regulations)

**When is it Income?**

Timing of taxation matters because of

Volatile income

Legislative changes in tax rate schedule

**The Realization Requirement**

Principal rationales for realization requirement (why don’t we tax pure asset appreciation (e.g. mere increase in value of stock))

- Valuation problem: It would be very difficult to value how much stock is worth (stocks fluctuate a lot)

- Efficiency problem: There are so many pieces of property to value, it would just be incredibly difficult

- Liquidity problem: It is unfair to tax someone on non-liquid property when he/she doesn’t have the cash to pay for it. We don’t want to force someone to sell their property just to pay their taxes.

- Continuity of Investment Argument: There is no change in taxpayer’s investment/risk. The taxpayer has not cashed out.

- Legal Formalism Argument: We need to hold to the formal rules of Section 1001 (in the context of **Woodsam Associates**)

**Eisner v. Macomber (1920)**

Macomber owned 2,200 shares of stock in Standard Oil. She received stock dividends that don’t increase the value of her ownership, just the number of shares she owns (subsequently devaluing the price/share). The IRS wants to tax her on these new shares.

- Issue 1: Did the stock dividends increase taxpayer’s wealth? (Economic Issue)?

Economics of stock dividends:

Original shares: 2,000 $360/share $720,000

New Shares: 1,000

Total Shares: 3,000 $240/share $720,000

There is no change in her actual economic value/wealth. Income was never derived from, or separated from the capital investment. The dividend was never separated from equity

- Issue 2: When can her prior increase in wealth be taxed (Constitutional Issue)?

- IRS: Focuses on the language of the code defining income as “whatever source” to determine that this is income is taxable

- Taxpayer: Focuses on the language of case law – “from labor, from capital, or both” – to determine that this is not taxable income.

- \*Court holds that stock dividends are not income. The Revenue Act, its focus on dividend gains, is unconstitutional

- Issue 3: Did the dividends realize her prior increase in wealth (Legal Issue)?

Holdings:

- Precise – Stock dividends are not income (Congressional response – now **Section 305**) unless you are given an option to take cash or stock dividend. Stock dividend alone is not income.

- Constitution – Macomber states that the source of the income matters, but this is overruled by the “uses” argument in Glenshaw Glass

- Legal – There is a realization requirement. There has to be some moment when Macomber cashes out. She hasn’t cashed out because she still has risk in owning the stock. Until she discharges some of that risk, she hasn’t had that cash-out moment, and she hasn’t realized income.

- She’s still **“subject to business risk”**

- **Policy** Rationales – What if the government had won this case?

Corporations would be much less likely to issue stock dividends knowing that they are taxable. Investor’s share of company/capitalization would not increase, but they would be taxed on it. Investors would want corporations to reinvest.

Corporations issue dividends to increase retained earnings, and, to lower share price while, at the same time, attracting new investors to buy in that wouldn’t otherwise be able to at the current high price.

**Potential drawbacks to non-taxation of non-cash dividends:**

- Revenue loss for IRS

- It might violate notions of fairness and horizontal equity (those people who don’t invest in stock market are adversely affected.

- It creates inefficiency by distorting investment choices and making unnecessary “subsidies” for savings

- It creates administrative difficulty in defining exactly what is and isn’t realization – difficult to find the disposition event.

- Horizontal Equity Problem w/ investor who uses cash dividend to buy more shares; BUT there is a pivotal intervention, the cash is given to the investor and he makes the decision.

**Key to *Macomber*:**

- Need a realization event in order to tax

- If there is no change in the investment risk (i.e., no “cash out”), then no realization event

**Helvering v. Bruun (1940)**

In 1915, taxpayer (lessor) starts lease with an end date of 2014. In 1929, the lessee tore down the building and built a new one with a 50-year useful life. In 1933, lessee defaulted, abandons the lease, and the property reverts back to the taxpayer. 1979 was the end of the building’s expected life and 2014 was the expected expiration of the lease.

- Issue 1: Should the landlord recognize income equal to the building’s value? Is there income?

- There is no quibbling on this issue. There was a net gain of $51,434.25.

- Issue 2: If it is income, when was that income realized?

- IRS: Government’s position is that income is realized when the lease reverts back to the landlord (1933 – year of lease abandonment). They reason that the landlord received the benefit of the building when it transfers back to him upon default.

- Taxpayer argues:

- Lease does not expire until 2014, even though there has been a default on the lease, and there is, thus, no more lease. Taxpayer argues that he hasn’t realized income until the lease reverts back to him.

- Income from this property will accrue over time leading to greater difficulty to tax in intervening years (economic argument)  
 - It is difficult to separate the income from the property from the income from the building (administrability argument)

- Income has to be derived from a particular source (capital or labor), and this is neither. The improvement is capital appreciation, not income, because the improvement was not separated or derived from capital. Therefore, there is no income until disposition (Constitutional argument)

- Court: Holds for IRS. Taxable gain does not need to be realized as cash derived from a completed transaction

“While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of taxpayer’s indebtedness, relief from a liability, or other profit realized from the completion of a transaction. The fact that the gain is a portion of the value of property received by taxpayer in the transaction does not negative its realization. It is not necessary to recognition of taxable gain that he should be able to sever the improvement begetting the gain from his original capital.” (Roberts)

- *Bruun* moves away from *Macomber*

- Congressional Response 🡪 Overturns *Bruun*: *Bruun* = H-S notion of income, but Congress decides it’s bad policy to tax Landlords at this time.

- **Section 109 (Improvements by Lessee on Lessor’s Property:** Gross income **does not include** income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

- §109 looks like huge windfall to LLs, BUT §1019 comes in

- **Section 1019 (Property on Which Lessee Has Made Improvements)**: Neither the basis nor the adjusted basis of any portion of real property shall, in the case of the lessor of such property, be increased or diminished on account of income derived by the lessor in respect of such property and excludable from gross income under Section 109.

- Taxpayer gets deferral (exclusion of income under section 1019, but the basis is adjusted so that taxpayer cannot get depreciation deductions, or tax will ultimately be derived at disposition.

- §1019 says that if we give you the §109 exclusion, then you do not get the increased basis; so instead of 109 being a blanket tax exclusion, it is actually a tax deferral

- the tax deferral appears to be nominally the same as taxing LL up front, but it’s actually much better for the LL b/c of the time-value of money.

\***Realization is a necessary, but not sufficient condition for taxable income.**

**Woodsam Associates, Inc. v. Commissioner (1952)**

In 1922, taxpayer buys property for 300k. In 1931, taxpayer mortgages property in nonrecourse debt for 400k. In 1934, taxpayer contributes the property to a corporation. In 1943, property is foreclosed and final disposition is made.

Issue: It is given that there is some taxable gain, but there is a question of just how much taxable gain there was.

Taxpayer Argument: Mortgaging the property for 400k is similar to a disposition/realization event. This, in the taxpayer’s eyes, was a constructive sale. This would increase the taxpayer’s adjusted basis to 400k. (Court wouldn’t be able to open this up because the SOL had run, i.e., we can’t look at the 100k gain) Taxpayer argues that the basis is stepped up to 400k.

IRS Argument: Adjusted basis is the original price that the taxpayer actually paid. The new mortgage (1931) is not the adjusted basis because this is not a realization event. There is disposition event. It is just a loan transaction. Taxpayer still held legal title. It is not constructive sale.

Court: Decides for IRS. Realization of gain was postponed. 1931 was not the moment of realization. Under 1001, this was not a disposition. Taxpayer still owned property, had legal title. Loan proceeds are not taxable income and do not represent a

disposition event.

- Under *Macomber*, it appears to be a realization event: (1) there is no Liquidity problem; (2) there is no valuation problem – bank did due diligence; and (3) there is a change in investment risk; BUT *Woodsom* adds a fourth requirement for realization: (4) does it adhere to legal formalism of §1001?

**Cottage Savings v. Commissioner (1991)**

Financial institution with mortgage portfolio ($6.9 M face value). Market tanks causing mortgage portfolio to decrease in value ($4.5 M FMV). Financial institutions to exchanged mortgage portfolios for “substantially identical” mortgage interests, and, subsequently, realized the losses for tax reasons.

Issue: Under 1001(a), do these mortgage swaps constitute a disposition/realization event that would allow the financial institution to realize a tax loss?

IRS Argument: This can only be a disposition of property (not a sale) under Section 1001 if the properties exchanged are materially different (**Treas. Reg. 1001-1(a) General Rule**). In making this determination, IRS argues that the court should use a highly complex test of economic substitution that would require an analysis of the attitudes of the parties, evaluation of the interests by the secondary mortgage market, and the views of the FHLBB.

Holding: This swap is a realization event b/c the assets were “materially different.” The Court disagrees with the Commissioner’s economic substitute argument saying that it has no basis in case law, it is too complex (and therefore, difficult to administer), and not in keeping with the structure of the Code (like-kind exception provision is put in the code; why would it be created if this wasn’t a realization event)

Justice Marshall: An exchange of property gives rise to a realization event so long as the exchanged properties are “materially different” – that is, so long as they embody legally distinct entitlements.

Implications: This is a highly formalistic application of realization. It is easy to administer and is practical, but it doesn’t necessarily take into account the reality/economic substance of the transaction. It also gives the taxpayer nearly complete control.

- *Cottage Savings* allowed institutions to “cherry pick” losses – easier to take advantage of losses

**Capital Losses (Section 1211)**

**1211(a)**: In the case of a corporation, losses from sales or exchanges from capital assets shall be allowed only to the extent of gains from such sales or exchanges.

**1211(b)**: In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of

1. $3000
2. The excesses of such losses over such gains

**-** This is another example of basketing/netting

- Policy Rationales:

- We don’t want to encourage sheltering of income, especially by corporations

- We don’t want to encourage cherry-picking of losses

**Non-Recognition**

**Basics – The Lock-In Effect**

- When a taxpayer has a built-in gain on an investment, a disposition event will force him/her to pay taxes on that gain. Holding the asset/investment will not create such a trigger. Thus, taxpayer may feel locked in. In addition, the stepped-up basis in **Section 1014** deters changing investments because taxpayer can just pass investment/property onto children.

- How can we eliminate/mitigate the lock-in effect?

- Eliminate the realization requirement – This isn’t going to happen

- Carve out exception where certain kinds of property exchanges defer tax liability, thereby encouraging investment (e.g., like-kind transfers)

- Lower the marginal tax rate for certain transfers (e.g., capital gains)

**Like-Kind Exchanges**

**Section 1031 (Exchange of Property Held for Productive Use or Investment)**

**(a)(1)** No gain or loss shall be **recognized** on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use, in a trade or business, or for investment.

Policy Rationales:

- Economic efficiency – we want capital to move. Lock-in effect is a deterrent. A non-recognition policy encourages the mobility of capital.

- \*Change in investment risk – the property is different, but the risk is still substantially similar because the property is of “like kind.”

- Under **1031(a)(1)**, personal use property is not eligible for non- recognition in like-kind exchanges.

- **Section 1031(a)(2) (Exceptions)**

Like-Kind Exchange non-recognition won’t apply to exchange of:

1. Stock in trade or other property held primarily for sale (inventory)
2. Stocks, bonds, or notes
3. Other securities or evidence of indebtedness of interest (*Cottage Savings*)
4. Interests in partnership
5. Certificates of trust or beneficial interests
6. Choses in action

**- Like-Kind Defined (Treas. Reg. 1.1031(a)-1(b))**

**- Section 1031(b), (c):** Define tax treatment of like-kind exchanges that are not solely made in like-kind (with boot) (e.g., cash)

- **Section 1031(d)**:

In the case of a like-kind exchange without boot, the basis is substituted from the original property to the new property to reach adjusted basis.

In the case of a like-kind exchange with boot, we substitute basis, subtract any money received and add any recognized gain (or subtract any loss) to determine basis

**Mechanics of a Like-Kind Exchange**

**-** Has there been a realized gain/loss? (**Section 1001** – Amount Realized – Adjusted Basis)

- What is the recognized gain/loss?

- Under **Section 1031(a),** if no boot is present, no gain/loss is recognized

- Under **Section 1031(b)**, if the exchange would be a like-kind exchange, and, if you’re not just getting the like-kind property (but something else to boot), then, you have to recognize an amount equal to the realized gain/loss, but not in excess of the boot.

- What is the basis of the received property?

- Under **Section 1031(d)**, Adjusted Basis of Received Property = Initial Basis – Boot Received + Recognized Gain/Loss

**Mechanics of Like-Kind Exchanges**

Important questions:

1. What’s the REALIZED gain/loss?

- 1001(a), (c)

- You start here because you need to see how much you’re gaining, without applying exceptions.

2. What’s the RECOGNIZED gain/loss?

- 1031(a); with boot=> 1031(b),(c)

- There are exceptions, and 1031(b) & (c) stand for the exceptions. This part determines the extent of taxes.

3. What’s the BASIS of acquired property?

- 1031(d)

- New 1001 analysis for in-kind exchanges!:

- What is realized gain or loss (A/R=>A/B=>gain/loss)?

- What is recognized gain or loss (A/R=>A/B (1031(d)) =>1031(a) or 1031(b), (c)=>gain/loss)?

**In Practice**:

Problem 1:

- TP1 in-kind exchanges property A to TP 2 in exchange for property B.

- TP1 valued A at $60k, but had an A/B of $40k; TP2 valued B at $60k

- What are the tax implications?

- MO for Like-Kind Exchanges:

- 1001 analysis (realization):

- A/R = $60k (as the amount received)

- Subtract A/B = $40k

- Realized Gain = $20k

- 1031(a) analysis (recognition):

-No recognized gain, as simple property transfer (1031(a)(1))

- 1031(d) analysis (basis):

- Carry over the basis from the previous TP: Basis=$40k (1031(d))

- Tax on $20k!

Problem 2

- Same as above, but TP2 gives TP1 property C, valued at $50k, plus $10k in cash.

- Tax implications?

- MO for Like-Kind Exchanges:

- 1001 analysis (realization):

- A/R = $60k (property + cash)

- Subtract A/B = $40k

- Realized Gain = $20k

- 1031(a), (b) analysis (recognition):

- Doesn’t apply—with the boot, go to 1031(b). Recognized Gain is the value of the boot, which is $10k. This amount taxed!!!

- 1031(c) analysis (basis)

- Carry over the basis of the original property, minus the amount received, plus the recognized gain.

=> $40k + $10k – $10k = $40k basis.

-NOTE: b/c the $10k as realized gain is taxed, it can apply against the amount received.

Problem 3

- Same as above, but TP2 gives TP1 property D, valued at $35k, plus $25k.

-Tax implications?

- MO for Like-Kind Exchanges:

- 1001 analysis (realization):

- A/R = $60k (property + cash)

- Subtract A/B = $40k

- Realized Gain = $20k

-1031(a), (b) analysis (recognition):

- Recognized gain is the lesser of the boot or the realized gain! = $25k v. $20k. = $20k.

- 1031(d) analysis (basis):

- Carry over the basis of the original property, minus the amount received, plus the recognized gain. Meant to properly assign basis, so when recovery of capital occurs, you know how much.

=> $40k – $25k + $20k = $35k basis!

Problem 4

- Same as above, but TP2 gives TP1 property E, valued at $25k, plus $5k. A is now worth $30k, but the A/B is $40k.

= Tax implications?

- MO for Like-Kind Exchanges:

- 1001 analysis (realization):

- A/R = $30k (property + cash)

- Subtract A/B = –$40k

- Realized Gain = –$10k

- 1031(a), (b) analysis (recognition):

- Recognized gain is the lesser of the boot or the realized gain! = $0.

- 1031(d) analysis (basis):

- Initial Basis ($40K) – Cash/Boot ($5K) + Recognized Gain ($0) = $35K of basis

**Carlton v. U.S.**

- Example of very confusing §1031 like-kind exchange

- Form matters for §1031 – one party tried to just pay in cash, didn’t have land to swap. Court: It **must** be like-kind exchange to qualify for 1031.

**Other Non-Recognition Provisions**

**- Involuntary Conversions (Section 1033)**

- if replaced w/ similar property, then no gain recognized

- if replaced w/ property not similar or cash, then may be recognized (see §1033(a)(2)

- Ex: Jesse has warehouse (FMV=100; A/B=80). Fire destroys it; 100 insurance. If Jesse builds new warehouse w/ proceeds, then:

(1) §1001 analysis = 100 realized gain from insurance

(2) 1033 analysis = if property is similar, then A/B = 80.

- §1033 ensures just tax deferral and not tax exclusion.

**- Leasehold Improvements (Section 109, Section 1019)**

**- Cancellation of Debt Income and its Exceptions (61(a)(12), Section 108(b))**

**Deemed Realization**

**Short Sale**

Blake borrows 100 shares of Google (from his broker) when Google is worth $500/share, and immediately sells the shares for $50k. But, he still owes the broker 100 shares of Google. Blake wants the stock price to go down so that he can buy it at a price below $500/share. That way, when he/she returns the shares to his broker, they will be worth less than $500/share and Blake can keep the difference b/w the current price and the $500/share he sold it at. If the value of Google rises, it is bad for Blake. He loses money b/c he has to buy the 100 shares at a higher price to give to his broker.

**Short against the Box**

Blake owns 100 shares of Google w/ adjusted basis of $1k and FMV of $50k. If he sells his stock outright, he realizes a $49k gain with a huge tax liability. But, he still wants to sell his stock so that he can diversify his investment portfolio.

Blake initiates a short sale. He finds a broker to borrow shares from. He subsequently sells those shares with the continued obligation to repay. Because he has the obligation to repay, the 50k he earns up front does not have immediate tax liability.

He effectuates realization without a realization event happening.

Blake eliminates his risk exposure b/c he already owns the stock in his portfolio.

If the price goes up, Blake still owns 100 shares and his investment will increase (and he hasn’t experienced a realization event). If the price goes down, he gains the benefits of a short sale (he can buy more shares back at a lower price to turn a profit and give shares back to broker). He also realizes a tax loss on those shares.

- Formal legal rights don’t comport with the substantive economic risk.

**Constructive Sale**

Constructive sale, evidenced in short-against-the-box-type transactions, contrast legal formalism with economic substance in wildly inconsistent manner. In the short against the box transaction, Bill still “owns” the share. There is no sale or realization. But, in terms of economic substance, Blake has liquidated his asset.

- Congress responded to these strategies with **Section 1259**

**-** In the case of a constructive sale of an appreciated financial position, taxpayer shall recognize the gain as if such position were sold/assigned/etc.

- Essentially, Congress says, “we care about Economic Substance.”

- Economic Substance trumps Legal Form

- Contrast w/ §1031 (like-kind exchange) and *Cottage Savings* where legal form mattered more

**Original Issue Discount (OID)**

What is it?

- Coupon bonds, zero coupon bonds etc.

- A coupon bonds is a debt instrument that pays regular interest (i.e. cash payment of interest)

- A zero-coupon bond is a debt instrument that pays back “only at maturity (i.e. no explicit annual interest payment)

- Original Issue Discount is the difference between the issue price and the investment price 🡪 the discount is the lower amount you loan out to receive a

greater amount later on.

- lender issues OID at a “discount” to the “face value,” or the price at maturity.

**Main Tax Issues for OID:**

(1) Stealth Tax – the value of the bond is increasing over time – we want to treat a coupon bond holder and zero-coupon bond holder the same even though the zero-coupon bond is back loaded.

(2) Mismatching – on one end is the corporation (using accrual accounting) that’s taking a yearly deduction for the increase in the bond, and on the other end is an individual investor (using cash accounting) who is not including the yearly increase in value in income b/c he’s not seeing any cash yearly.

(3) Substance vs. Form – the Economic Substance of the situation trumps the Legal Form of only getting paid at maturity. BUT we ignore the liquidity of the tax payer.

(4) Horizontal Equity:

If someone invests $60 in a CD w/ annual interest receipts of 10%, they are taxed on this interest income

- But, if that person bought a zero-coupon bond for $60 that pays $100 in 5 years, that person is taxed on it. If we waited until she received the $100 in year 5, there would be a huge deferral benefit. OID treats the investment as though it is gaining interest each year.

**General Rule on OID Income:** To the extent that a debt instrument does not provide for current payment of an adequate amount of interest, interest must be accrued (included in currently in income)by the obligee regardless whether the obligee is a cash-method or accrual-method taxpayer

**Section 1275(a)(1)(A)**: the term “debt instrument means a bond, debenture, note, or certificate or other evidence of indebtedness

**OID for Debt Instruments w/ Definable Issue Price and Redemption Price**

Subtract Issue Price from Redemption Price (Redemption Price – Issue Price = OID)

- Ex: Abe buys 5 yr. Eli Lilly bond that pays $100 at maturity for $62. how to determine OID and imputed interest income? $100 - $62 = $38 (OID)

OID is treated as interest earning ratably over the term of the loan

Calculate the interest rate necessary to move from issue price to redemption price over the term of the bond: **Redemption Price = Issue Price\*(1 + Interest Rate)^Term**

**- OID for Debt Instruments with Redemption Price, no Definable Issue Price (Transfers of Property)**

Calculate Imputed Principal Amount (**Section 1274(b)(1)**): Discount each individual yearly interest payment, and principal/interest payment in the final year. Add these numbers together to calculate the imputed principal amount or the value of the debt obligation in the first year.

OID = Redemption Price – Imputed Principal Amount

Calculate yearly interest earned by multiplying present value of amount owed by the applicable federal rate (**Section 1274(d)**)

Subtract stated interest from interest earned to find Annual OID (This is the Recognized OID)

Add Annual OID to Imputed Principal Amount to attain Imputed Principal Amount for second year

Repeat for subsequent years

**Section 467 Applies OID to Rents**

**Exceptions to OID Rules**

**Sales of Principal Residences (Section 1274(c)(3)(B))**

**Sales of Farms for Less than $1 Million (Section 1274(c)(3)(A))**

**Sales Involving Payments of Less than $250,000 (Section 1274(c)(3)(C)**

**OID Rules applied to Property Sales:**

Charles owns a “cotton” farm, Big Bud (FMV=$386K), which he sells to IBM for zero-coupon bonds that have an issue price = $386K; redeemable in 10 years for $1,00K. Tax implications?

- When C makes deal, he doesn’t receive anything, he sells his farm for $386K; he’s taxed on the OID income each year.

- What if IBM gives C a note paying $1,000K in 10 years?

- same thing; he’s taxed on the OID income each year.

- What if Charles’ basis in the cotton farm was $300K?

- take Present value of promissory note, which is $386K.

- Do the §1001 analysis:

- Amount Realized = $386K

- Basis = $300K

- Recognized Gain = $86K b/c of disposition event.

- What’s the other analysis?

- Charles will take the bond with a FMV = $386K

- Basis is $386K

- The bond’s OID interest is taxed each year.

**Open Transactions** – taxing future (uncertain?) payments

**Burnet v. Logan (1931)**

Taxpayer owned mining stock in mining company with basis of $180k. Another company bought all the shares of the mining company, including shares of taxpayer. Taxpayer receives cash disbursal of $120k and a promise from the new company of future payments derived from profits of mining ore. The amount of these future payments was very uncertain.

IRS Argument: Taxpayer sold her shares for $220k (120k cash disbursal + 100k (present value of future payments from new company)) 🡪 “closed transaction”

Taxpayer argument: Taxpayer wants “open transaction” treatment. She argues that the promise of future payments had no ascertainable value in 1916 and should be ignored. They are like stocks. They don’t have value because there is still risk. She also argued that she should be able to recover her entire basis before reporting any gain. Thus, she was required to report no gain in 1916 (basis was $180k, amount realized was $120k = tax loss of$60k)

Court: States that it is too difficult to value the PV of the payments; adopts an Inaja-like basis-first rule. Why? TP still susceptible to vagaries of the commodity market.

Implication:

- Use of open transactions allows taxpayer deferral and basis recovery before paying taxes. This is a very pro-taxpayer decision. 🡪 If you are able to put enough uncertainty into future payments, then you may get tax benefits of deferral

- This is also easier on administration of the tax

**The Installment Method**

A method under which income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

**Income Recognized = Gross profit/contract price**

Only applies after applying rules of unstated interest (**Section 483)** and OID (**Treas. Reg. 15a.453-1(b)(2)(ii))**

**Section 453(a)**: Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method

**Section 453(b)(1):** The term installment sale means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.

**Section 453(b)(2)(A), (B)**: Installment sale does not include dealer dispositions and inventories of personal property

**Section 453(c)**: The term installment method means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

**Example:** S sells property (A/B $300k) for $500k to be paid over 5 years in equal installments ($100k/year)

- Under the installment method, not all of the $100k/yr will be income

- Income Recognized = (500 – 300)/500 -> Ratio = 2/5 -> Only 2/5 of any amount received will constitute recognized income

- Gain Recognized in a year: 100k Realized \* 2/5 = 40k Recognized

- Recovery of Basis in a Year: Leftover – 100k – 40k = 60k

- Installment method (§453) makes *Burnett* only apply in very rare situations.

**Constructive Receipt**

**Treas. Reg. 1.451-2(a)**: Income, although not actually reduced to a taxpayer’s possession is constructively received by him in the taxable year during which it is credited to his account set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given

- This makes us think about the “dominion and control” of Glenshaw Glass

- Even if you are a cash taxpayer, we look to economic substance and the level of control you have over the amount. (If you wait to pick up your May paycheck

until January, you still have constructive receipt in May)

- \*Not going to respect cash-accounting always and everywhere

-Income “constructive receipt” when: (1) credited to TP’s account; (2) set apart for TP; (3) made available so it can be drawn upon anytime by TP or TP can get it w/ notice.

**Amend v. Commissioner (1949)** – Constructive Receipt turns on Legal Entitlements

**-** Farmer (cash taxpayer) adopts practice in 1942 of delivering wheat in August and not accepting payment until January. Income straddles the taxable year.

- Issue: When does taxpayer claim income?

- Holding: Constructive receipt does not apply because there was a contract between the farmers. Court treats this as an issue of form vs. substance. Farmer wasn’t trying to avoid the fiscal year, it was just his method of doing business. This also create administrability problems because he didn’t have the money at the time he sold the wheat.

- Not really a huge revenue loss for the IRS 🡪 just deferring for one year

- when not a huge revenue loss for IRS, courts are more likely go with Legal Form over Economic Substance.

**Economic Benefit Doctrine**

**Economic Benefit Doctrine**: An individual on the cash receipts and disbursements method of accounting is currently taxable on the economic and financial benefit derived from the absolute right to income in the form of a fund which has been irrevocably set aside for him in trust and is beyond the reach of creditors.

**Pulsifer v. Commissioner (1975)**

Father and 3 kids win a horse racing lottery. The children’s winning are placed in a bank account.

Issue: When can the children be taxed on their winnings?

Holding: Court holds against the taxpayer, finding that income was currently taxable upon winning the sweepstakes. Thus, it cannot be deferred. Court uses the

economic benefit doctrine to assert that the children had an **absolute right to the income** in trust, they were absolutely going to receive it at some point, and it was **beyond the reach of creditors**.

**Transfers Incident to Marriage/Divorce**

**Property Settlements**

**US v. Davis (1962)**

**-** Taxpayer transfers appreciated stock to ex-spouse, pursuant to a divorce agreement.

- Issue: Does taxpayer recognize gain and if so, how much.

- Holding: This transfer is a taxable event and gain is determined by the value of the consideration transferred by the taxpayer 🡪 the intangible rights that the wife

gave up as consideration equals the value of the stock

**Section 1041 (Transfers of Property Between Spouses or Incident to Divorce)**

**Section 1041(a)**: No gain or loss shall be recognized on a transfer of property from an individual to a spouse or former spouse, but only if that transfer is incident to the divorce.

(overturns *Davis*).

**Section 1041(b)**: In the case of a transfer of property described in subsection (a), the property shall be treated as acquired by the transferee by gift, and the basis of the transferee in the property shall be the adjusted basis of the transferor. (“carryover” or “transfer” basis)

- No deduction for transferor, exclusion for the transferee. (it’s gift-like treatment). Transferee takes on basis of transferor.

**Antenuptial Settlements**

**Farid-Es-Sultaneh v. Commissioner (1947)**

In 1924, Kresge made a prenuptial transfer of appreciated stock (w/ A/B of $12k and FMV of 800k) to Sultaneh. Sultaneh acknowledged receipt of shares in antenuptial agreement. In 1928, the two were divorced. In 1938, Sultaneh sold the stock.

Issue: What is the basis of the stock sold by the taxpayer?

Holding: The basis of the stock is its FMV. This was a transfer paid for with consideration. It does not receive gift treatment.

**Alimony v. Child Support/Property Settlements**

As a general rule, alimony is deductible to the payor and includible/taxable to the payee. Child support/property settlements, on the other hand, are not deductible to the payor, and are excludible to the payee.

**Alimony** (follows Haig-Simons notions of income, as well as the matching principle)

**Donor Orientation**

**Section 215 (Alimony, Etc., Payments)**

**- 215(a) (General Rule)**: In the case of an individual, there shall be allowed as a deduction an amount equal to the alimony or separate maintenance payments paid during such individual’s taxable year.

- If alimony is deductible for payor (i.e., default rule not altered by contract via §71(b)(1)(B), then alimony payments are treated as an above the line deduction for the payor (§215(a)(i); §62(a)(10)); thus, it lowers AGI 🡪 important b/c if above the line, you know you get the whole deduct, but if below, not so sure; also, AGI acts as floor for misc itemized deducts.

**Donee Orientation**

**Section 71 (Alimony and Separate Maintenance Payments)**

**-**Under **71(b)(1)**, alimony payments must be made in cash **-** Under **71(b)(1)(A)** and **71(b)(2)**, the alimony payment/separate maintenance payment must be received by a spouse (or on behalf

of spouse) under a divorce or separation instrument.

- Under **71(b)(1)(B)**, the parties must not have previously agreed that the payment be excludable by payee and non-deductible to payor.

- Allows flexibility to reverse the default rule: both parties may contract that payments be non-deductible to payor and excludable by payee; depending on payor’s/payee’s marginal rates, it may be beneficial for both parties

- Under **71(b)(1)(C)**, parties to an alimony transfer must not live in the same household at the time of payment. This guards against friendly divorces, favorable single persons rate.

- erases potential for paper divorces for tax reasons

- Under **71(b)(1)(D)**, payments as part of an alimony transfer cannot continue after death. This ensures that alimony payments go to ex-spouse payee and no one else

**Exceptions to §71:**

- Under **71(c)**, alimony payments are differentiated from child support payments. Child support payments do not receive the favorable treatment of alimony for donors because it is thought that payments to a spouse as alimony will allow the spouse donee to more easily bear the burden of taxation. Child support payments create greater difficulty for spouses to bear that burden. Any supposed alimony payment that terminates upon death/maturity/etc. of a child will be treated as child support. This is the emphasis economic substance over form.

- **71(f)** deals with the problems of distinguishing between alimony payments and property settlements by focusing on the first few years of alimony. A donor taxpayer may try to front load alimony payments to escape tax liability on his property settlement. When there is excessive front-loading of alimony payments, those payments will not be considered alimony, but rather, cash property settlements.

**Divorce Problem:** Suppose H & W are getting divorced and as part of the settlement:

(1) H Agrees to transfer stock to W with FMV = $750K, A/B = $550K. Tax implications? The actual transfer does not trigger any tax. BUT at what basis does W take prop? W takes prop with basis of $550K (§1040).

(2) H agrees to pay W $30K/year to be reduced to $15K/yr when their son, T turns 18. Tax implications? Half of it looks more like child support payment – so it’s treated as such (§71(c). $15K looks like alimony, so it will be deductible for payor (§215(a); §62(a)(10)) and it will be includable in payee’s income (§71(a)). The other $15K looks like child support so it will be non-deductible by H and excludible by W (§71(c)).

**Income Splitting**

**Income From Services: Diversion by Private Agreement**

**Lucas v. Earl (1930)**

**-** In 1901, spouses initiated property sharing contract (a joint tenancy with right to survivorship)**.**

**-** Issue: Does the whole amount of salary and attorney’s fees earned by Earl belong to him, or do we respect the estate contract into which the spouses have entered which would only allow taxation on half of this income?

**-** Holding: Court rules in government’s favor. All of the income belongs to the taxpayer. The court basically says that income from services go to the person who performed those services. You cannot contract out of it. Holmes sees this as an avoidance schemeand says that tax cannot be escaped by anticipatory agreements and skillfully devised contracts.

**-** Implications: If the case had gone the other way, the government would lose lots of revenue because married couples would make contracts and agreements in order to split income.

- Legal Form v. Economic Substance: In form, this contract splits up the income. The tax should follow accordingly. In substance, one spouse is making all the money. He should be taxed on it, then transfer it to his spouse.

- Justice Holmes’ fruit tree metaphor: trees = TPs; fruit = income; if fruit came from one tree, we can’t move it to another tree.

**Income From Services: Diversion by Operation of Law**

**Poe v. Seaborn (1930)**

**-** Seaborn family members file separate tax returns. Each holds some property on their own, but Washington is a community property state. Seaborn family splits income and each files one-half of the total community income in each tax return.

- IRS argues that this is analogous to Lucas v. Earl, and that all income should be apportioned to the husband’s return.

- Holding: Court holds in favor of taxpayer because, as a community property state, under Washington state law, Ms. Seaborn had a, “vested right in the property…including salaries.”

- Implications

- Poe v. Seaborn is distinguishable from Lucas v. Early because, in Seaborn, the property vests in each of them immediately by community property provisions in state law.

- BUT contracts are also enforced by state law

- The inability to split property through contract in Lucas v. Earl involved an opt-in by the couple through contract. They chose that action. Community property splitting in Poe v. Seaborn is state law. The Seaborns did not have a choice

**The Marriage Penalty**

**-** The nature of differential income levels and the marginal tax rate in the Code creates interesting incentives for filing jointly or separately on one’s income tax return

- The marriage penalty occurs where one’s tax liability increases with joint filing as opposed to summing tax liabilities of married filers separately.

- Involves situations where each member of a married unit earns roughly the same amount

- Married couple (C and D) have similar amounts of taxable income

- C & D’s combined income places them in a higher tax bracket and hence, their tax liability as a married unit > the sum of their individual tax liabilities.

- Recently we eliminated the marriage penalty for lower tax brackets, but we still see it at higher income levels

**The Marriage Bonus**

- Exists when one member of a married unit earns significantly less than the other, or nothing

- If couple files jointly, they will be taxed at a lower marginal joint rate than marginal single rate if filing separately; also, potentially, they’d get a larger standard deduction.

- Marriage/Tax Neutrality is impossible because we cannot adhere to all three principles of:

1.) Progressivity (vertical equity – rising marginal tax rates)

2.) Horizontal Equity between married units – treat all married units same and all single people same

3.) Neutrality between marriage and remaining single – we IGNORE this; we give marriage bonuses and penalties based on fairness, but we ignore the horizontal equity between married and single people.

-**Disincentives for Secondary Worker**:

- more disincentives from tax structure for secondary worker to go back to work.

- we saw this with the fact that we don’t tax imputed income from household work and childcare.

- the marriage penalty is another reason

- BUT there are non-tax reasons for secondary worker:

1.) more net income (possible),

2.) psychic benefits of working, and

(3) keeping skills intact and up to date

**Income from Property & Gifts as Carve Outs**

**Blair v. Commissioner (1931)**

**-** Petitioner, original beneficiary of a trust, assigns life estates to his children proportionally. The trust had an investment portfolio, which can be described an income producing asset. He takes no reversionary interest, giving all rights in the trust to his children.

- Issue: Who to tax? The Donor/Assignor or the Donee/Assignee?

- Holding: Donor is not taxed on the transferred property; Donee is taxed. The donor has given away the right to receive a continuous flow of income. Donor transferred property, not income. He has extinguished control over a future income stream. This is analogous to a gift of stock or real estate.

- KEY: Donor gave **entire control** to his children.

**Income-Splitting Problem**: Megan, an artist, gives her son a recently completed painting. 6 months later, her son sells the painting for $100K. Who’s taxed on sale?

- The son: makes sense per the Haig-Simons notion of income, he is the one who received the economic benefit.

- What if son sold painting immediately after getting it b/c Megan instructed im to sell to buyer?

- Megan is taxed. She never relinquished control of the painting. She was passing on the painting to an agent – likely a lower income bracket TP – thus, this is an assignment of income issue. Shifting tax burden to lower TP in family.

**Helvering v. Horst (1940)**

**-** Father controls bonds (loans), which he detaches the coupons (interest) from, and assigns to his son.

- Issue: Who should pay the tax? This implicates an issue of differing marginal tax rates of father and son.

Holding: The father/donor must ultimately bear the tax because the remainder, and hence, control over future income streams, are retained by the father.

Implications:

- If the Court wanted to do this just right, they would have taxed the assignee on the economic gain of the coupon (adjusted for NPV), and the assignor on the remainder and on the other coupons he controls. But, this would be administratively difficult.

**Carve-Outs Problem:** Sarah owns a bond; Sarah gives right to coupons to Michael, and gives rights to principal to Mandy. Who ought to get taxed? Who does get taxed?

- Both parties ought to get taxed; both are receiving different economic benefits.

- BUT under our second best, workable system of rules: Mandy gets taxed b/c she has retained the right to the principal.

- This is a form of surrogate taxation; instead of taxing both parties, we only tax Mandy.

**Section 1286** overrules ***Horst*** in the context of bond-stripping.

- Bond-stripping is done by sophisticated financial institutions: they take interest portion apart from principal. IRS taxes both parties (the one getting interest and one holding principal). I.O. holder taxed on interest income; and P.O. holder taxed on principal. P.O. is taxed like OID income 🡪 growth of the P.O.

**Economics of Carve-Outs**

**-** Trust set up with a bond for $100 that pays interest of $20 for 5 years

- Bond is then stripped such that one assignee retains the income interest (I.O) of $20 for 5 years and the other assignee retains the remainder, the $100 principal to be paid at the end of 5 years.

- Economically, for bonds, we would tax both assignees annually based on the interest they have gained

- Under **Section 1286**, both parties are taxed on the respective economic gain from a stripped bond

**Personal Deductions, Exemptions, and Credits**

*The different kinds of deductions*

(1) Those that are required to tax NET INCOME (wages paid to employees, etc.)

(2) Unrelated to the production of income (“Personal Deductions” – home mortgage interest deduction, personal exemptions)

- Incentives/subsidies

- accurately define income

- fairness/ability to pay.

(a) Above the Line Deductions (income-producing deductions, alimony, etc.)

(b) Below the Line Deductions (casualty losses, other itemized deductions)

*Why is AGI so important?*

- Effect how you can allocate below the line deductions (serves as a threshold or floor)

- Miscellaneous Itemized Deductions have to exceed 2% of AGI

- NOTE: Misc Item Deducts are a subset of all Itemized Deductions.

- Casualty Losses have to exceed 10% of AGI in order to take them

- Medical Expenses have to exceed 10% of AGI in order to take them

- Affects what your marginal tax rate will actually be.

*Why have personal deductions, exemptions, credits?*

*-* Fairness/horizontal equity

Creates a sort of zero-bracket level for certain income producing individuals and families. People with families and dependents will receive greater personal exemptions (lowering their tax burden) than individuals making similar income without families and dependents. A mother with three kids has greater spending burdens and less leftover income after mandatory spending than a woman making the same amount of money with no children.

- Subsidizes particular behavior

Personal exemptions may incentive having children. The home mortgage interest deduction may incentivize taking a mortgage out on a house instead of renting.

- Efficiency

We don’t want to nickel and dime the IRS, or force the IRS to calculate every single last deduction. Only 1/3 of taxpayers take itemized deductions, so use of the standard deduction is a matter of efficiency for both taxpayers and the IRS.

*Limitations*

- “Personal Deductions” are below the line deductions. They have to exceed the standard deduction to be worthwhile.

- Miscellaneous Itemized Deductions, under **Section 67**, have to exceed 2% of AGI in order to take them

**Earned Income Tax Credit**

Form of wealth transfer. It is a negative income tax (tax credit) for earning a certain amount of money. It is one of the major forms of social welfare, targeting the working poor. It incentivizes people to work, even if they don’t have much money. The EITC has a phase-out as income goes up.

**Phantom Marginal Tax Rates**

**-** The top tax rate is 35%. But, if, as income goes up, deductions are phased out, your effective rate might increase stealthily.

- Phase-out of deductions is a way to target certain taxes. For example, the EITC is focused on the poor

- Effective Marginal Rate = Tax Liability/Gross Income

- \*Main Concept of Phantom is that your Effective Rate is sometimes actually GREATER than your Statutory Rate.

**Casualty Losses**

- If you have insurance, then you’re not compensated b/c you’ve already been made whole; BUT if it’s a personal loss and you’re uninsured, then we want to help b/c of notions of fairness 🡪 your ability to pay has diminished.

**Section 165 (Losses)**

**- 165(a) (General Rule)**: There shall be allowed as a deduction any loss sustaind during the taxable year and not compensated for insurance or otherwise.

- **165(b) (Amount of Deduction)**: The **basis** for determining the amount of the deduction for any loss shall be the **adjusted basis** provided in **Section 1011** for determining the loss from the sale or disposition of the property

- We award the deduction using the adjusted basis, instead of the FMV because we want to consider what the person invested in the property. Unrealized gain or appreciation (shown in FMV) has not been taxed and we don’t want to give a deduction on gain that hasn’t yet been taxed. Also, there may be some consumptive value in the difference between adjusted basis and FMV 🡪 you’ve gotten use out of the property over time, so that use should be taken out of the compensation received.

- **165(c) (Limitation on Losses of Individuals)**: In the case of an individual, the loss deduction shall be limited to:

1. Losses incurred in a trade or business;
2. Losses incurred in any transaction entered into for profit though not connected with a trade or business
3. Except as provided in subsection **(h)**, losses of property not connected with a trade or business or a transaction entered into for profit if such losses arise from fire, storm, shipwreck, or other casualty, or from theft 🡪 notions of sudden, unexpected, unusual losses!

**Policy** Concerns for Casualty Losses

- We have a tax benefit for personal assets because loss or destruction of that asset lead to a decrease in wealth and concurrent reduced ability to consume. If I have a car and it is totaled, I am denied the ability to consume/use my car, or sell it.

- Casualty loss is a built-in insurance mechanism for people with personal items. But, this insurance mechanism actually discourages people from getting insurance. This is moral hazard b/c it’s free insurance.

- BUT it’s only a deduction (i.e., TP is only compensated for a % - whatever TP’s top marginal rate is – of the total loss).

**Dyer v. Commissioner (1961)**

Taxpayer has a cat with a mental disorder, which causes it to knock over an expensive vase. Taxpayer argues that this was the first time he learned of cat’s disorder, so it was unexpected, and thus a casualty loss. Court disagrees. Things break in the normal vicissitudes of life. This kind of stuff happens all the time.

**Waddell F Smith v. Commissioner (1948)**

Taxpayer loses prize dog. Court doesn’t hold argument for water. Court wants a threshold amount to get rid of pesky cases like this.

**Chamales v. Commissioner (2000) –** OJ’s neighbor

**-** Property owner purchases house right next door to O.J. Simpson’s. After the two murders at the house, there was a lot of media attention, looky-loos, etc. This causes a loss in the value of the property. Taxpayer claims casualty loss deduction

- 9th circuit holds that the loss (1) is not permanent, (2) does not have the

suddenness element contemplated by the treasury regulations, and (3) that there is no physical damage. Thus, court holds that this is not a casualty loss.

**Mechanics of Personal Casualty Loss Deduction**

Step 1: Determine the Loss Amount

Loss amount is limited to adjusted basis under **Section 165(b)**

Step 2: Determine amount not covered by insurance (Subtract insurance receipts)

Step 3: Net Personal Casualty Losses (**165(h)**)

**165(h)(1)**: Loss must exceed $100 (Subtract $100). $100 is enough to keep pesky cases out of tax courts. We could also think of this as an insurance deductible.

**165(h)(2)**: Net casualty loss allowable only to the extent that it exceeds 10% of AGI

- Thus, the deduction is the amount over 10% of AGI

- Formula: Casualty Loss = Net Cas Lst (loss – insur payment) – 100 – (AGI \* 0.10)

- EX: AGI=$100K; Net Casualty Loss=$11K

$11K - $100 – ($100K\*0.10) = $900

**Extraordinary Medical Expenses**

**Section 213**

**213(a)**: There shall be allowed as a deduction the expenses paid during the taxable year, **not compensated for by insurance or otherwise**, for medical care of the **taxpayer, his spouse, or a dependent**, to the extent that such expenses **exceed 7.5% of AGI**.

- Formula: Med Exp Ded = (Qualf Med Cost) – (AGI \* 0.075)

- Value of Overall Deducation = Med Exp Ded \* Top Marginal Rate

- The 7.5% threshold tries to distinguish between ordinary medical expenses and extraordinary misfortunes

- It also serves efficiency purposes. By setting the 7.5% bar, people won’t have to spend a lot of time figuring out if their expenses qualify.

- Deduction threshold creates a tax disincentive for people to buy medical insurance. Medical expenses will be high in some years and lower in other years. When expenses are high, people will claim the deduction. When they are low, they’ll just pay it.

- The medical expense deduction is like mandatory “free” insurance w/ a “co-pay” equal to 100% minus TP’s top marginal rate, and a “deductible” related to AGI that applies on an annual, rather than per event basis.

- When combined with **Section 106(a) (Exclusion for Employer-Provided Health Insurance)**, there is a great incentive for employer to provide health care coverage to employees, but with lower wages/compensation. Furthermore, this statutory regime encourages group health plans with low deductibles (even a high deductible won’t trigger the 7.5% AGI threshold.

- High deductibles are seen as a good thing because people spending their own money will think twice about taking wasteful trips to the doctor. Leads to lower rates of moral hazard.

- In response to these concerns, Congress passed **Section 223** providing for **Health Savings Accounts**

- In order to qualify as an HSA, a coverage plan must have a deductible of at least $1k and less than $5k for individual coverage and double that for family coverage (**Section 223(c)(2)**)

- Employees with coverage falling in this range may claim a tax deduction for his/her contribution to the HSA of the lesser of the amount of the deductible OR $2,250/$4,500 for individuals/families (**Section 223(b)**)

- Deduction may be claimed by taxpayers who do not itemize their deductions, is not phased out as income rises, and is not subject to AMT.

- Where an employer contributes to HSA on employee’s behalf, contributions are deductible to employer and excludible by employee, amounts earned in the account are non-taxable (**Section 223(e)**) and amounts paid out of the account to employees are non-taxable (**Section 223(f)(1)** - so long as they are used to pay medical expenses

- **Policy** Concern: Large deductibles and the relative ability for an employer to enter into HSA’s there is created a great disparity in HSA enrollment between high income and low income taxpayer.

**What is Medical Care under §213?**

**213(d)** **(Definitions)**: The term medical care means amounts paid for:

- The diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure of the body

- Transportation primarily for and essential to medical care

- Qualified long-term care services

- Insurance covering medical care

**Taylor v. Commissioner (1987)**

- Allergic taxpayer cannot mow lawn. He pays others to mow his lawn for him.

- Issue: Can the taxpayer deduct because of his allergic reaction?

- Holding: No deduction. Taxpayer has children who could mow the lawn. In addition, there is no §213 medical expense in his but-for causation.

**Henderson v. Commissioner**

Family has child in wheelchair. Family buys van for transporting him. Later, they modify the van with a wheelchair lift in response to complications from his medical condition. The family then takes depreciation deductions for the van and tries to claim them as medical expenses. Court holds that these expenses (depreciation deductions) were not an “expenses paid” for medical care under §213. Depreciation deductions are an

accounting tool, not a payment of expenses. Congress had in mind out-of-pocket expenses.

**Ochs v. Commissioner**

Wife diagnosed with cancer, has a great deal of trouble speaking. Husband sends children to boarding school. Husband tries to deduct cost of boarding school because it was undertaken on the advice of the doctor. Court says that these expenses are family/personal and are not directly related to the medical condition.

* Under §262, people can’t take deductions for expenses that are primarily personal consumption

**Policy Incentives created by §213:** Current Medical Cost v. Preventative Care

(1) Dr. Tells patient he is obese and needs to attend weight loss clinic

First Q, Is obesity a disease? Yes 🡪 then it can be deducted?

(2) Dr. tells overweight patient to join gym:

First Q, is being overweight a disease? No 🡪 then no deduction.

- IRS will say letting gym memberships be deductible is a slippery slope; will health food shopping be deductible? Other preventative care such as Toothpaste?

**Charitable Contributions**

**Section 170 (Charitable, Etc. Contributions, and Gifts)**

**170(a) (General Rule)**: There shall be allowed as a deduction any charitable contribution payment which is made within the taxable year.

**170(c) (Definitions)**: For purposes of this section, the term charitable contribution means a contribution or gift to or for the use of

1. A state, US possession, or political subdivision, **but it must be exclusively for public purposes**
2. A corporation, trust, or community chest, fund, or foundation
3. Created or organized in the United States, possession, etc. under the law of the United States
4. Organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if not part of its activities involve provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals
5. No part of net earnings of which inures to the benefit of any private shareholder or individual
6. Cannot be disqualified under 501(c)(3).

**Treas. Reg. 1.170A-1(g)**: o charitable deduction is allowable under **Section 170** for a contribution of services. However, unreimbursed expenditures made incident to rendition of services to an organization that accepts contributions that are deductible may constitute a deductible contribution. **(If you make unreimbursed expenditures in the course of performing services for a charitable organization, those expenditures may constitute a deductible contribution.)**

Ex. If you are performing volunteer work, the bus fare to get to the volunteer job site would be deductible, if it was unreimbursed.

**170(b) (Percentage Limitations)**

**170(b)(1)(A)**: Charitable contributions to churches, educational organizations, hospital/medical care facilities, quasi-government entities, private foundations, etc. shall be allowed to the extent that the aggregate of such contributions does not exceed 50% of taxpayer’s contribution base for the taxable year. **(In practice, the contribution base will be AGI)**.

- **170(b)(1)(B)** **(Other Contributions)**: Where the general rules doesn’t apply (for charitable organizations other than the ones described in **170(b)(1)(A)**), the charitable contribution shall be allowed to the extent that the aggregate of these other contributions does not exceed lesser of:

- 30% of taxpayer’s AGI, or

- The excess of 50% of taxpayer’s AGI allowable under (A).

**Policy Rationale (This is a very large hole in our tax system)**

(1) Substituting private donation for government spending/activity to prop these organizations up is a practice that will promote general welfare. Providing tax deduction for such activity will incentivize it.

(2) Donation/charity should be encouraged. Altruistic tendencies are a good thing.

(3) The government recognizes its limits. There is value in having decentralized pluralistic support rather than centralized government provision.

(4) This is altruism, not personal consumption (but there is no doubt that charity provides psychic income)

(5) We don’t tax the organization/the people who are served by these organization because these are exactly the people we want to help. By taxing them, we are undermining them.

Why use a deduction?

- it promotes wealthier ppl to give 🡪 deductions are hinged to top marginal rate

Canada treats charitable giving as a tax credit

- not hinged on top marginal rate 🡪 they argue ppl on top are going to give anyways

**- Charitable Contribution Problem**: John has AGI = $200K (no NOLs), donates: $80K to alma mater (IU), endows a Tax

Policy Center; and also donates $40K to private charity

- how much can he deduct?

- IU = public charity. Thus, it is §170(b)(1)(A).

- All $80K deducible b/c it is under the 50% of AGI threshold

- Private charity = §170(b)(1)(B).

- only $20K of the $40K is deductible b/c the aggregate contribution to private charities cannot exceed the lesser of (i) 30% of AGI, or (ii) 50% of AGI included in (A).

- B/c of the $80K, there’s only $20 possible charitable deductions left.

**Donating Appreciated Property**

- Suppose instead of giving cash, you donate appreciated property

- ex: You donate Google stock worth $10,000 that you paid $1,000

- You get to deduct the fair market value (§170(a)(1))

Is this fair?

- the concern is that the $9,000 realized gain the hypo was never taxed

-in this case, it is not taxed at all b/c charity is tax exempt and, as the giver, you’re not taxed on it when you give it

- in fact, you get a $9,000 deduction

-the IRS has considered this; thus, there is an exception to the default rule of §170(a)(1) and Treas. Reg. §170A-1(c): §170(e)

§170(e) – the contribution amount allowed for deduction is “reduced by the sum of” –

(A) Not long-term capital gain (e.g., short-term capital gain; inventory of business)

- You deduct adjusted basis

(B) Long-term capital gain

- You deduct the fair market value

\*POLICY – want it to be a real investment – not speculation

**Donating Appreciated Property Cont.**

- **Treas. Reg. 170A-1(c)**: If a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in **170(e)(1)**, **Treas. Reg. 1.170A-4(a)**, **170(e)(3), and Treas. Reg. 1.170A-4A(c).**

**-** Gifting property/security to a charity might allow you not to be taxed on whatever gain accrued in that property and to deduct the entire fair market value. This is a problem akin to the stepped-up basis of inherited property. **170(e)** tries to deal with this.

- **170(e)** **(Certain Contributions of Ordinary Income and Capital Gain Property)**

- **170(e)(1)** **(General Rule)**: The amount of any charitable contribution

of property shall be reduced by the sum of:

1. The amount of gain which would not have been long term capital gain (i.e. short term capital gain or ordinary income) if the taxpayer had sold the property at FMV; and
2. In the case of a charitable contribution

Of tangible personal property, patents, copyrights, trademarks, trade name, trade secret, software, taxidermy property, etc., the amount of gain which would have been long term capital gain if the property contributed had been sold at FMV.

**In essence, if the property is not long term capital gain (ordinary income/short term capital gain), the amount of the charitable contribution will be the adjusted basis. If it is long-term capital gain, we undertake an analysis of the tangible personal property, but, more than likely, the amount of the charitable contribution will be the fair market value of the property.**

Policy:

The act of donation doesn’t create a realization event because we wouldn’t have the money to pay the taxes that we might have to pay on realization. This is the point of charitable giving.

**Private Benefits or the “Quid Pro Quo Test.”**

**Section 102/Section 274(b)** **v. Section 170**

- The standard for gifts is donor intent (detached and disinterested generosity – **Duberstein**); BUT for charitable contributions there is a higher standard b/c of the deduction benefit that we use to subsidize charitable giving – we have to balance subsidy w/ potential non-tax benefits that donors get.

- In **Section 170**, we have a higher standard (quid pro quo test – analysis of **substantial benefit**)

**Section 6115**: Any quid pro quo contribution of over $75 must include written statement of quid pro quo nature and the value received

**-** Charitable organizations have also instituted fee structures that blur lines between charitable contributions and payment for services (buying box seats for fine arts providers, etc.)

**Ottawa Silica Co. v. US (1983)**

Mining company acquired property, transferred 50 acres to school + 20

acres of a right away. The school was going to build an access road on the right of way for the benefit of the high school, but it would also benefit the mining company (would allow mining company easier access to development of other parts of its property, access to main roads). This will significantly enhance the value of the mining company’s property. Mining company claims a $415k deduction for a charitable contribution.

- Issue: Is this really a charitable contribution?

- Holding: No deduction. Taxpayer received benefits **“greater than those that inure to the general public from such transfers.” (Substantial Benefit/Quid Pro Quo Test)** In this case, the general public would receive the benefit of a new school. But, the taxpayer received the benefit of the access road that contributed to the value of his property.

- Business v. non-business expenses: Where business benefits are implicated, donor’s intent is seen as irrelevant if the business benefit is substantial. In that case, no deduction is allowed.

- If benefit is incidental to TP, then TP may be able to use the charitable tax deduction. However, if the TP receives benefit, or expects to receive additional substantial benefit, courts are likely to conclude that quid pro quo exists and not allow the deduction.

**- DuVal v. Commissioner**: DuVal, a real estate developer sought rezoning of a parcel of property by the government. *In return****,*** he contributed a portion of his property as a site for a library in an effort to “give something back.” Court held for DuVal, stating, “*we must determine the taxpayer’s primary or dominant interest or purpose in making the transfer…To resolve this question, we do not examine only taxpayer’s statements of his or her subjective intent. Rather we must make an objective inquiry into the nature of the transaction to determine whether what is labeled a gift is in substance a gift.”*

**Overvaluation of Contributed Property**

- Often seen in the context of contributions of works of art

- **Tax Reform Act of 1984 (Imposing Substantiation Requirement)**

**-** Donor must obtain a qualified appraisal from an independent person and attach appraisal summary to his/her tax return

- **Revenue Reconciliation Act of 1983**

- Taxpayer claiming charitable contribution deduction of over $250 must be able to substantiate the deduction with written acknowledgement by donee with reference to FMV (**170(f)(8)**)

- **170(f)(11)**: Where a contributed property is not readily valued, and for which there is a deduction of over $500, taxpayer must include, with his return, “a description of such property and such other information as the Secretary may require.”

**NCAA v. IRS**

**Rev. Rul. 84-132**: Payment to University’s athletic scholarship program providing a taxpayer with opportunity to purchase preferred seating is not deductible under **Section 170**. The IRS saw this as too much personal consumption/benefit.

**Announcement 84-101**: IRS temporarily suspended this ruling to hold public hearings on implications of above ruling. This demonstrated the influence of universities/collegiate athletics.

**Rev. Rul. 86-63**: Clarifies, but affirms quid pro quo rule for donations to college athletics.

**Tax Reform Act of 1986 (Section 1608)**: Carved out exception to IRS Rev. Rul. for “Described Institutions” – basically, this meant the University of Texas, and LSU.

§**170(l):** Response to this rifle shot tax provision. Allowed for 80% of amount paid for the right to buy preferred seats to be deductible.

**Religious Charitable Giving & Benefits Received**

**Hernandez v. Commissioner**

**-** Members “donate” to Church of Scientology for “training sessions” and “auditing.” Taxpayers want to deduct their payments as a charitable contribution.

- Issue: Are payments to church for auditing and training services charitable contribution deductions?

- Holding: No deduction allowed because of the inherently reciprocal nature of the exchange (**Doctrine of Exchange**) 🡪 it is a Quid Pro Quo

- O’Connor Dissent: Points out that is treatment is Inconsistent with the permission of deductions for pew rental, synagogue fees. How are those any different than this?

**Bob Jones University v. US (1983)**

**-** BJU actively pursues racial discrimination at its school, institutes disciplinary rule that there is no interracial dating and immediate expulsion will result for partners in interracial marriage, mingling, etc.

- Issue: Is BJU a charity under **Section 170** & **§501(c)(3)**?

- Taxpayer argument: BJU takes a plain reading of **Section 170**, arguing that it is a charitable organization by the words “educational organization.” BJU is such an organization so it should not be denied its exempt status.

- 4th Circuit: This is an issue of statutory interpretation. 501(c)(3) and 170 are part of a larger context. Congress didn’t give any indication of how it wanted to enforce the provision. Thus, the IRS has broad discretionary authority to rule permits them to deny BJU tax exempt status.

- §170 and §501(c)(3) embrace common law notion of “charity”

- Tax exempt institutions must meet certain standards of charity; must serve a public purpose, and not be contrary to established public policy (we have a firm national policy against banning interracial relationships).

**Limiting the Interest Deduction**

Pre-1986 Act: All interest on personal loans was deductible, leads to huge revenue loss

Post-1986 Act: Limited deductibility of personal loans (no longer a deduction for interest on credit card, auto loan for personal use, etc.

**Section 163 (Interest)**

**163(a)**: There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

**163(h)** **(Disallowance of Deduction for Personal Interest)**: For a taxpayer other than a corporation, no deduction shall be allowed for personal interest paid or accrued during the taxable year

**163(h)(2) (Personal Interest Defined)**: Personal interest means any interest allowable as a deduction under this chapter other than:

- Interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee) (**You are still allowed to deduct for business interest as a personal taxpayer** if the debt is used to generate income for a side business)

- Any investment interest under **Section 163(d)**

- Any interest which is taken into account under **Section 469** in calculating passive activity gain/loss

- Any qualified residence interest under **Section 163(h)(3)**

Any interest allowable as a deduction under **Section 221** (interest on educational loans)

**163(h)(3)** **(Qualified Residence Interest Defined)**

1. Qualified residence interest means any interest which is paid or accrued during the taxable year on
2. Acquisition indebtedness (building, buying, or substantially improving a new home); or
3. Home Equity indebtedness (using the equity you’ve already built up in your home)

\*On a purely formalistic legal aspect, the limitation is different for each of these. If you’re buying/acquiring/building a house, you can borrow up to $1 M with interest deductible. For home equity indebtedness, this is not so (the limitation is $100k).

- We are trying to encourage home ownership. Using your home as an ATM is not the same as going out and buying a new house.

- **Policy**: (1) encourage home ownership & pursuit of the “American Dream”

(2) Horizontal Equity: aligns (a) home owners w/ debt and (b) home owners w/out debt

- BUT we ignore (c) renters

- Renters pay housing costs w/ after-tax dollars, but tax code provides no relief.

- Home Owners are not taxed on imputed income from owning home (i.e., they don’t pay any rent to themselves); and home owners w/ debt get to deduct their interest payments via §163(h).

- **Drawbacks**: (1) huge tax expenditure (i.e., massive revenue loss for IRS)

(2) May encourage ppl to buy homes that can’t afford them

(3) distortion of decision-making 🡪 may lead to too many homes

- **Solutions:** - put reasonable limitations on §163(h): why allow TPs to deduct interest payments on 2 homes? Why is the mortgage allotment so high (i.e., $1M)?

- Problems though with making these reforms is that the current tax deductions are likely already priced into the home prices; thus, this reform could make home prices drop even lower.

**Section 221 (Qualified Education Loans)**

- This is an above the line deduction (**Section 62(a)(17)**, designed to cut students a break and encourage educational spending – awesome that it’s pre-AGI b/c TP guaranteed full deduction; and it doesn’t impact standard deductions

- BUT upside down subsidy b/c attached to Marginal Rates;

Deductions for other **Taxes paid**

**Section 164 (Taxes)**

**- 164(a) (General Rule)**: Except as otherwise provided, the following taxes shall

be allowed as a deduction for the taxable year within which paid or accrued:

- Real Property Taxes (state, local, foreign), Personal Property Taxes (state, local, foreign), GST tax on income distributions, qualified motor vehicle taxes, etc.

**Policy Rationales:**

(1)This is not voluntary consumption. State and local taxes are not a proper definition of economic income.

- On the other hand, as Holmes said, “taxes are the price we pay for civilized society.” We benefit from police, fire, education, medical benefits, etc. that government provides.

- BUT it’s not a voluntary consumption

(2) Supporting state and local governments in this way (from the federal perspective) encourages them to provide services.

**Personal and Dependency Exemptions**

**Section 151 (Allowance of Deductions for Personal Exemptions)**

**Section 151(b)**: Provides personal exemption to each taxpayer (for joint returns, 2 exemptions – annually adjusted for inflation)

**Section 151(c)**: Provides exemption for each dependent.

**Section 152 (Dependent Defined)**

- Qualifying Child Dependent: Child/child’s descendant/sibling of taxpayer that is under 19 (if a student, under 24), that has not provided more than half of his/her own support, and has the same principal place of abode as taxpayer for over ½ of year.

- Qualifying Relative Dependent: Child/child’ descendant/parent/parent’s ancestor/sibling/aunt/uncle/cousin/in-law/member of taxpayer’s household that has a gross income less than exemption amount and receives more than half of support from taxpayer and is not a qualifying child.

**King v. Commissioner (2003)**

Couple was never married, had a child. Father was claiming child as dependent, per their contractual agreement. Mother married another guy and they were caring for the child – so, they started to claim child too.

- Issue: Which parent is entitled to dependency exemption?

- Lopez argues that he is entitled to exemption because of contractual agreement.

- BUT usually we let parent who takes care of child 51% of the time to claim dependent, and that is the mother/King.

- Court decides that the statute applies to people whether they were married or not. By signing her right to take the exemption away, King grants exemption to Lopez.

- Form of Contract trumps the Economic Substance.

**Earned Income Tax Credit**

**Section 32**: Provides a refundable credit to low-income taxpayers who have some earnings. This is a government transfer payment (anti-poverty program). The EITC gives strong economic incentives for low income taxpayers to work. This incentive continues to a level, but begins to phase out once you accrue a certain income.

* It’s a refund check, but you have to be working to get it.

**Policy Rationale**:

- Reduce the burden of social security taxes on the working poor

- Remove poverty-level taxpayers from the tax rolls and provide subsidy to low- wage workers

- Helps working families (singles doesn’t benefit as much)

- Increases federal support for child care expenses

- Assures a “living wage” or a minimum standard of living for the working poor through effectively a “negative income tax”.

- Income redistribution (work-fare based)

**Child Tax Credit**

**Section 24**: Provides a tax credit of $1,000 for taxpayer for each qualifying child. This credit reduces as income rises.

**Mixed Motive Spending**

Mixed motive spending implicates a continuum between purely personal consumption (non-deductible and part of the tax base) and the cost of producing income (business/inventory – deductible not part of tax base)

**Policy Overview**: Unwarranted business deductions may lead to:

- Subsidized personal consumption (For a 35% taxpayer, a fully deductible $100 meal would be the same as a $65 non-deductible meal)

- Equity Concerns:

- Vertical: people with high income get to take benefit, low income people don’t

- Horizontal: People who make the same income but are in different fields may or may not get to take deductions

- Macro-economic inefficiencies 🡪 may lead to distorted decision-making

**Business Expenses**

**Section 162 (Trade or Business Expenses)** (i.e., side business – we want to tax NET)

**162(a)**: In general there shall be allowed as a deduction all the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business including

- Salaries/compensation for personal services rendered

- Traveling expenses (including non-extravagant meals and lodging) while away from home in pursuit of trade or business

- Rentals/other payments for continued use/possession for the trade/business where there is no taking of title/equity

**Section 212 (Expenses for Production of Income):** In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid for or incurred during the taxable year

- For the production or collection of income

- For the management, conservation, or maintenance of property, held for the production of income

- In connection with the determination, collection, or refund of any tax

**Section 262 (Personal, Living, and Family Expenses)**

**262(a) (General Rule)**: Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses

**Mechanics**

**- Section 162** deductions are §62 above-the-line deductions 🡪 come off top of gross income before AGI

- **Section 212** deductions are below-the-line, §67 miscellaneous itemized deductions.

- §212 is more restrictive /bc of §67 (i.e., must meet 2% of AGI and also be > standard deduction)

- Policy reasons for difference:

- This is for both administrative reasons (we don’t want people to deduct every last profit-seeking activity) and mixed motive reasons (there may be some personal consumption in subscribing to the WSJ)

**Hobby Losses**

**Nickerson v. Commissioner (1983)**

Nickerson wanted to end his advertising career, purchased dairy farm. He starts fixing it up, hires tenant farmer, starts making improvements, etc. However, he loses money on the farm, retains his checks and receipts and tries to claim business expense deductions for these losses to use against his taxable income from his salary.

- Issue: Is this just a hobby, or is farming is true business purpose?

- **Section 183(a)**: Activities engaged in by an individual or an S corporation, if such activity is not engaged in for a profit, no deduction attributable to such activity shall be allowed. (**Court is looking for bona fide intent/primary motive with respect to objective factors**)

- *Nickerson* Holding: Court ultimately decides that taxpayer was taking on activity for a profit. None of the individual factors in the treas. Reg. were dispositive. But the court did find that the taxpayer was seeking future profits sincerely. It doesn’t matter whether their profit goals were realistic.

- **Treas. Reg. 1.183-2(b)(1)-(9):** Lays out relevant factors that must be taken into account in determining whether taxpayer carries on activity intended for a profit. Includes the manner in which taxpayer carried on the activity, the expertise of the taxpayer or his advisors, time and effort expended by taxpayer in carrying on activity, expectation that assets used in activity may appreciate in value, success of taxpayer in carrying on other similar/dissimilar activities, taxpayer’s history of income or losses w/r/t activity/ amount of occasional profits, if any, which are earned, financial status of taxpayer, elements of personal pleasure/recreation.

- Also look to how well records are kept

- AND if had a profit in 3 of the last 5 years, then it’s probably going to be deemed a for-profit activity.

**- Section 183(b)**: If the activity is not engaged in for a profit:

- Unrelated deductions that would be allowable whether or not the activity is being undertaken for a profit are allowed.

- Activity deductions (deductions related to the activity) will be allowed only to the extent of the gross income of the activity (basketing).

- NOTE: §183 is a §67 misc. itemized deduction

- Policy of §183(b) and §162(a):

- deduction-limiting provision b/c says certain things can’t be deducted;

- deduction-creating provision b/c cleanses some forms of mixed-motive spending.

**Travel and Entertainment Expenses**

**Entertainment Expenses Theory:** If taxpayer/lawyer takes prospective client to lunch at taxpayer/lawyer’s favorite restaurant, how should the law treat the taxpayer portion of the lunch?

- Shouldn’t be deductible because taxpayer loves this restaurant. It is personal consumption.

- But, the client’s lunch might be deductible as part of the general notion of what it takes to get business.

- This is an issue of theoretical accuracy/practical administration.

- *Benaglia* & “all or nothing” taxation 🡪 here we look at how much is truly personal consumption and how much isn’t

**Rudolph v. United States (1962)**

**-** Insurance company provides employee and his wife a trip to NY for making certain sales quota.

- Issue: Is a deduction allowed under **Section 162/212**? Is this personal consumption or an involuntary business expense?

- Court looks to the dominant motive and purpose in taking the trip. But whose purpose is determinative? The employer’s? The employee’s?

- Holding: The business meeting and the group luncheon did occur during the trip, but the rest of the time was spent traveling, sightseeing, entertainment, free time, etc. **This is personal consumption**. In addition, the husband was able to take the trip as a bonus, as compensation for a job well-done.

BUT then Congress stepped in with §274, which allows a lot of this.

**Section 274 (Disallowance of Certain Entertainment, etc. Expenses)**

**274(a)(1)**: No deduction otherwise allowable under this chapter shall be allowed for:

(A) Activities that constitute entertainment, amusement or recreation **unless** the taxpayer can establish that the activity was **directly related to**, or immediately preceding/following a substantial and bona fide business discussion **associated with** taxpayer’s trade or business.

**274(n)**: Amount allowable as a deduction for food/beverages, entertainment activity shall not exceed 50% of the cost/expense.

**274(m)(3)**: Deductions only allowed for a spouse for travel expenses if the spouse is employee of person claiming the deduction or the spouse has a bona fide business purpose for the trip

**274(d)**: No deduction allowed unless the taxpayer substantiates the record with the amount, time and place, business purpose, business relationship, etc.

**Moss v. Commissioner (1985)**

- Moss, an attorney at a law firm, has lunch every day at Café Angelo with other members of firm, discusses cases, approves settlements, etc. Moss tried to deduct $1k for costs of lunches over those years.

- Court says the meals don’t qualify for §162(a) b/c meals are NOT “necessary” business expense

- The frequency is a concern and that no clients are at the lunches.

- No need for “social lubrication” to build camaraderie among wokers – only needed for clients”

**Travel Expenses Theory**

**-** Taxpayer/lawyer lives in Bloomington but works for firm in Indianapolis. If taxpayer drives to court/client from work, are expenses deductible?

- Going to court seems like a good business purpose under 162.

Is the drive to and from work deductible?

- No. The decision where to live is a personal choice 🡪 too much personal consumption

**Commissioner v. Flowers (1945)**

Taxpayer lived in Jackson, MS. Begins to represent railroad company in Mobile, AL. Eventually, he takes position with company, makes arrangement with company that he will live in Jackson and commute to Mobile. Taxpayer wants to deduct commuting expenses.

Court’s statutory analysis focuses on 3 conditions necessary to qualify for deduction under **Section 162(a)(2)**

(1) Expense must be a reasonable and necessary traveling expense

(2) Expense must be incurred “while away from home”

(3) Expense must be incurred in the pursuit of business

Court looks at condition 3, won’t give deduction b/c it’s not in pursuit of biz.

KEY to Travel expenses is the “while away from home” element b/c there is a duplicative expense/spending

- should be allowed to deduct this b/c it will get us at NET income; you already spent money to cover food/shelter at home 🡪 shouldn’t be forced to do it again while away from home.

**Hantzis v. Commissioner (1981)**

Boston area law student/taxpayer spends summer at NYC firm and tries to deduct travel and living expenses.

IRS argues that NYC was her home. These travel/living expenses were not deductible because she wasn’t “traveling” when she incurred those expenses. IRS also argues that she is still a student and isn’t involved in a trade or business.

Taxpayer argues that these deductions are part of the definition of income.

Holding: There is no deduction because NYC was taxpayer’s “home.”

**Childcare Expenses**

**Smith v. Commissioner (1940)**

- Petitioners claim deduction for employing nursemaids for childcare.

- TP tries to make “but for” argument

Holding: Childcare expenses here are personal choice, not deductible (also choice to have kids).

**Section 21:** Creates a sliding scale credit for expenses related to the care of a dependent. It has phase-outs and a great deal of complexity in calculation. Since tax credit, it’s unhinged to the marginal tax rate.

**Section 129**: Employee exclusion for dependent care assistance provided by employer

**Clothing Expenses**

**Pevsner v. Commissioner (1980)**

Petitioner is manager of YSL store. As part of her employment, she is required to wear brand clothing for marketing purposes. Taxpayer tries to deduct expenses of clothing she wears under **Section 162**.

IRS: Argues that the clothes could be worn outside of work. This has too much personal consumption, both in wearing the clothes and taking the job.

Tax Court: Found for taxpayer, doesn’t question elements of test. Focuses on the fact that taxpayer lived frugally, that the clothes were not suited to taxpayer’s every day wear, not really in line with her standard of living.

5th Circuit: Uses 3-factor test. Clothing would be deductible if:

(1) Clothing was required as condition of employment

(2) Clothing is not adaptable to general use; AND

(3) Clothing is not worn for general use

Holding: No deduction b/c clothes were objectively suitable for ordinary use

- Problem w/ tax ct’s focus on TP’s frugal living is that it would be an administrative nightmare to look at each TP’s subjective situation.

**Legal Expenses**

**US v. Gilmore (1963)**

Taxpayer, soon to be ex-husband goes through nasty divorce. He hires a lawyer to handle his spouse’s accusations of infidelity. He deducts these legal expenses because he owns care dealerships that he derives income from, and if the allegations are true, he would lose some income-producing property and money-making ability. According to taxpayer this should be a maintenance of revenue-producing property under **212**. Legal fees will protect that income stream.

IRS: Looks to origin and nature of the fees. These legal fees stem from the divorce and are thus personal

Court: looks at prior case law, horizontal equity concerns, legislative history of **212.** Court holds for IRS and states that legal fees related to divorce are personal.

**Educational Expenses**

**Carroll v. Commissioner (1969)**

Police officer takes night classes to get his degree in preparation for law school. He deducts the cost of these courses under **162(a)**.

Taxpayer argues that the courses are related to his job skills as a detective.

Appellate court: No deduction allowed because there was not sufficient nexus between his expenses and his employment. These courses are not required. There isn’t enough business, too much personal consumption.

**Treas. Reg. 1.162-5 (Expenses for Education)**

1. **General Rule**: Expenditures for education are deductible under 162, if they aren’t expenditures under **(b)(2)** and **(b)(3)**, and if the education:
2. Maintains or improves required skills of employment OR
3. Meets express requirements of the employer/law/regulations
4. **Nondeductible educational expenditures**: Educational expenditures under this subchapter are personal expenditures or constitute an inseparable aggregate of personal and capital expenditure

(2) Minimum educational requirements

(3) Qualification for new trade or business

- Educational expenses are deductible if either (a)(1) or (a)(2) is true and neither (b)(2) or (b)(3) is true.

- *Carroll* failed b/c of (b)(3) requirement.

**Educational Outlays – Problems**

Which of the following TPs would e entitled to a current deduction?

1. Lawyer incurs expense of tax planning course, as part of CLE requirements

YES

2. TP takes courses toward tax LLM

a. recent JD grad going straight to LLM

in §162, says it must be incurred “in carrying on any trade or business”

- and the student isn’t in a trade or business yet

b. current attorney who is a lawyer

what are the factors?

* on face of statute, fits §162, he’s in trade or business
  + look to treasury reg:
  + we need to know what kind of practice he’s currently in:
  + i.) if he’s getting some tax work, and wants to learn more
    - not a lot of personal consumption – looks like it will be deductible

ii.) if he likes tax and sees it as a way to get more business

A. may not be deductible b/c there is some personal consumption

B. Could be under (a)(1) b/c …

iii.) current regulatory attorney goes back to get LLM at night to work in private sector

A. deductible – same (a)(1)

B. not deductible – looks like the beat cop going back to school to be a detective in *Carroll* – it looks like a new vista of opportunity

3. Sales manager enrolls in full-time MBA, while continuing employment

*- Allemeier v. Comm.* – he works at a sporting goods store

- TP argument – (a)(1) analysis – manager wants to be better at managing

- Court finds for TP 🡪 allows him to deduct it b/c says MBA is merely improving current management skills, not preparing him for a new vista of opportunities.

Hypo: if employer pays for employee to go back to school, employer would likely get to deduct under §162; but would the employee have to include it in gross income?

- The logic of §119 might fit – forced personal consumption – but 119 is food and lodging

- The logic of §132 – Certain Fringe Benefits -

BUT then people created Pre-paid Tuition Plans

- A “short-cut” method allowed TP/Consumer to skip the intermediary and forgo taxable interest income

- this looks a lot like OID principles/theories – where you would have annual accrued interest that you would be taxed on

- BUT OID doesn’t apply b/c this isn’t a debt instrument

- So this appears to be a tax evasion or at a very least tax avoidance problem

- BUT the social policy rationale is that we want to encourage people to save for college

- So, Congress created §529 now provides **exemption** for distributions from a qualified program for qualified higher education expenses not as good as Health Savings Account though b/c have to use after-tax dollars to put into the 529 account

- Distributional Impact?

- Who can save for college? Are those the people who ought to be saving for college?

New Trade or Business – Problem

TP is IRS lawyer in NYC. Moves to CA and claims deduction for CA bar review course

What are the federal income tax implications?

- Likely denied for two reasons b/c it looks too much like personal consumption

1. personal choice to move to CA, and personal choice to take bar review course

2. being licensed in CA bar as well as NY is a “new trade or business”

**Current Expenses v. Capital Expenditures**

**Theory:** The difference between a current expense and a capitalized expenditure

**Section 263**: you cannot take a deduction for a long-term expenditure; BUT where do we get at what is allowed; no particular section of code – but §167 helps

**Section 167**: Depreciation deduction for exhaustion, wear and tear of

- Property used in trade or business

- Property held for the production of income

**Section 446:** Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. If no method of accounting is regularly uses/method of accounting does not clearly reflect income, the Secretary will decide the proper method.

**Treas. Reg. 1.461-1(a)(1)**: The One Year Rule: If you produce income from an asset with a useful life longer than a year, then it should be capitalized.

**Policy**: - It helps us get at NET income

* we want to clearly reflect income:

- Want to match income and expense

- want to draw nexus between income and expenses

- Most of the time TPs prefer Current Expenses (b/c time-value of money); but there may be times when you want capitalized (i.e., mixed business/personal asset, such as a house) – benefits from higher basis, such as casualty loss

**Example:** Megan’s t-shirt business:

(1) salaries to salespeople:

§162 – current expense

(2) purchased t-shirt press machine:

- capital expenditure is added to basis (§263)

- AND take depreciation deduction overtime (§167)

(3) purchase of land

- capital expenditure added to basis (§263)

- Recovery of basis at sale (§1001)

- NO depreciation

**Encyclopedia Britannica v. Commissioner (1982)**

EB hired publishing company to produce Dictionary of Natural Sciences. EB copyrighted and sold product, other company was responsible for production. EB treated expenses for production as ordinary and necessary business expenses, immediately deductible.

Issue: Is business spending to acquire a manuscript a deductible current expense or a capital expenditure to be recovered over time?

Held: No current deduction; must be capitalized.

The manuscript will yield income over a period of years in sales. Under the matching principle, we need to match up the yield of this income with amortization over time to reach the correct annual net income. In this case the payments must be capitalized because the expenditures are unambiguously identified.

Implications: Companies were more likely to just handle this type of publication in- house rather than contracting out. Publishing in-house would yield currently deductible expenses whereas contracting out would force amortization/capitalization.

**UNICAP Rules of Section 263A**

Requires capitalization of direct and indirect costs related to sale of real or tangible property

**INDOPCO and Its Aftermath**

**INDOPCO v. Commissioner (1992)**

- INDOPCO was involved with M&A discussions with Unilever. As part of negotiations, lawyers/bankers were paid $2.5 M in relation to the merger and how to structure.

- Issue: How should this be treated?

- Prior case law indicates that a separate and distinct asset can be currently deducted.

- Holding: Investment banking fees incident to merger must be capitalized because of the future benefits. There is no need for a separate and distinct additional asset.

**Reaction to INDOPCO**

(1) Advertising and training costs – Rev. Rul. 92-80

(2) Severance Pay – Rev. Rul. 94-77

(3) Creating Intangibles – Treas. Reg. §1.263(a)(4)

- capitalized

(4) Facilitating Acquisitions/changes in capital structure – Treas. Reg. §1.263(a)(5)

**Policy to capitalizing self-created assets**: they're capitalized because TPs are inherently permitted to deduct costs of earning income. What they do is take a depreciation deduction for self-created assets meant to make a profit *over time*. If it was an immediate profit, then I think a deduction would be permitted that year (as an ordinary and necessary business expense, § 162). If you recall, Mehrotra paired this discussion with that of accrual accounting.

**Real and tangible property:** same. Profit earned over time.

**Midland Empire Packing Co. v. Commissioner**

Meatpacking plant has a nuisance issue with a nearby oil refinery. Oil leaks into basement, water source. Meatpacking company has to spend money to oilproof its basement.

Issue: Is this an ordinary and necessary business expense uner **162,** or does it need to be capitalized?

**Treas. Reg. 1.162-4**:

Cost of incidental repairs that don’t materially add value or prolong the life of property may be deducted as current expense as long as acquisition/cost of production/gain or loss of basis of plant, equipment, property is not increased

Repairs that are replacements (arrest deterioration, appreciably prolong life of property) shall be capitalized and depreciated/charged against depreciation reserve.

- Holding: Court finds for the taxpayer. This is a current expense because it does not prolong the life of the asset. This repair hasn’t expanded the base of income they could accrue. It is the same income they would have made if they didn’t have the problem with the oil.

- Taxpayer also argued that this is a casualty loss. Court dismisses saying that there is no loss. But, the taxpayer has expenses that include the cost of the concrete lining/repair expenses. There is a fixed value that could demonstrably be evidence of the loss.

**Mount Morris Drive-In Theatre Co. v. Commissioner (1956)**

Taxpayer clears land to build drive-in theater. This leads to substantial increase of water drainage to adjacent property. Taxpayer installs new drainage system under threat of law suit. Taxpayer argues for a repair (current deduction). Court holds that this should be capitalized because of the foreseeability of the spending. It should have been part of the initial construction, and thus, should have been capitalized from outset.

**Tax v. Financial Accounting**

* Tax Acc: you want Net income to be lower; want to minimize your tax liability

- “run it by legal”

* Financial Acc: you want net income to be higher for shareholder value

- “run it by accounting”

**Depreciation/Amortization**

**Section 167(a)**: There shall be allowed as a depreciation deduction a reasonable allowance **for exhaustion, wear and tear** (including a reasonable allowance for obsolescence)

- Of property used in the trade or business, OR

- Of property held for the production of income

**Policy:**

- We want to match income properly and properly define net income. We want to include all expenses against net income. If we didn’t include depreciation on the baker’s oven, it won’t be a proper valuation of income. If we allowed a current deduction, we would be understating income.

- We apply it to the production of income (not just business) because that income is going to be taxed. To be fair and accurate, deduction should be granted for wear and tear (income will not be produced in perpetuity).

- Economic Incentives – Accelerating depreciation incentivizes people to buy property used for trade/business/producing income. This creates macroeconomic activity, stimulus.

**General Conditions that Determine Deductible Depreciation**

Must be a business/trade/income producing asset

Must have a finite and determinable useful life

**Computing Depreciation**

Economically Sound Method: Kelly Blue Book your car after each year of its use. Subtract that blue book value from purchase value. Difference is the deduction. Repeat this every year. This is easy for cars because there is a deep secondary market for this product. This is not so for every product.

Straight Line Method: administratively easier: (cost – salvage value) / (useful life yrs)

Double Declining Balance Method: Used to front load depreciation deductions, pay less tax early on, encourage investment.

**Depreciation of Tangible Property**

**Section 167(c)**: The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in **Section 1011**, for the purpose of determining the gain on the sale or other disposition of such property.

- **Section 167(b)(11)**: “salvage value”

**Section 168(c), (e)**: Determines useful life/recovery period for depreciable assets

- (e)(3) – gives particular classifications

**Section 168(b)**: Determines the method/rate of depreciation

- ex: Real Property = straight-line method

- Farm biz property = 150% method

- Other property = 200% method

- **Section 168(d)**: “applicable convention”

**Recapture**

You take depreciation deductions off ordinary income. But when you sell a business asset, it is a capital gain. This is important because there is a tax preference for capital gains. Recapture recharacterizes the income to prevent a double tax benefit. This is implemented in **Section 1016(a)(2) and Section 1245**.

- we have all this acceleration depreciation that we’ve frontloaded to give TP benefit of time-value of money; THUS, recapture is important b/c it stops TP from also getting capital gains benefit.

Ex. GC buys oven (§1245 property) for $10k. In years 1-2, GC takes total depreciation deduction of $3k (A/B = 7k).

At start of year 3, GC sells property for 9k -> 2k gain is ordinary income.

At start of year 3, GC sells property for 11k -> 3k of gain is ordinary income; remaining 1k of gain is capital gain

- if it wasn’t for §1245, GC would get $4K capital gains.

**Goodwill and Other Intangible Assets**

**-** Plenty of assets are not readily tangible. These assets are known as goodwill, going concern, etc.

- **Self-created Intangibles** (e.g. patent)

**Section 167(a)**: Allows for generous amortization treatment (not Accelerated Cost Recovery Systems)

- **Purchased Intangible Assets** (e.g. goodwill)

**Section 197**: Allows for amortization of such intangibles ratably over 15 years after the intangible was acquired.

* **Goodwill Amortization – Problem**
  + Grandma’s Cookies (GC) is thinking of expanding by either (1) acquiring a popular competitor, Mom’s Brownies, or (2) expanding internally by making brownies and issuing a marketing campaign to announce its new products.
  + Tax implications of two options with regards to (1) goodwill vs. (2) marketing?
    - (1) §197 – you would amortize whatever goodwill you acquired from MB.
    - (2) §162 – all of the marketing is immediately deductible
      * which is better tax implications?
        + option 2

**Capital Gains/Losses**

**Special Rates for Dividends and Other Capital Gains**

**-** A dividend is a distribution by a corporation to its shareholders. It isn’t exactly interest. Dividends do not fall easily into the two sub-categories of the character of income (ordinary income and capital gains)

- Differentiating between ordinary income and capital gains – Capital gains receive a tax preference because their benefits and tax consequences accrue further into the future. The rate schedules are, thus, different.

- Dividends are taxed on capital gains rate

- Why do dividends receive a tax preference?

- Encourages investment in corporation

- Corporate income is taxed twice (at corporate level and at individual level). - Mitigating the double taxation of corporate income provides a rationale for such a preference.

**Section 1222 (Other Terms Relating to Capital Gains and Losses)**

**- Short Term Capital Gain/Loss –** Gain/Loss from the sale or exchange of a capital asset held for not more than one year, if and to the extent such gain/loss is taken into account in computing gross income.

**- Long Term Capital Gain/Loss** – Gain/loss from the sale or exchange of a capital asset held for more than one year, if and to the extent that such gain/loss is taken into account in computing gross income.

- **Net Capital Gain** – The excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.

**Section 1221 (Capital Asset Defined)**

- Capital asset means property held by the taxpayer but does not include:

- Stock in trade/inventory or property held primarily for sale in ordinary course of business

- when you sell inventory, it usually counts as Ordinary Income; thus, it shouldn’t count as a capital gain

- Property used in course of business that allows for depreciation or real estate used in trade or business

- Copyright, literary/musical/artistic composition, letter/memo

- In general, capital assets seek to deny capital gains/losses for the ordinary operations of a trade or business

**Section 1(h) (Maximum Capital Gains Rate)**

Generally, net capital gains (excess of long term capital gains over short term capital losses) are taxed at preferential rates. Net short-term capital gains are taxed as ordinary income.

**Policy Rationales for Capital Gains Preference**

(1) Bunching – Stock is purchased at one time and appreciation occurs over a period of time. Taxing all at once is seen as unfair because the increase occurred over a period of time and taxation occurs at a single point. Thus, there should be a capital gains preference (but, isn’t there an argument that there was a benefit that the person wasn’t taxed at all during that time).

(2) Lock-in Effect – Taxing at lower rates will encourage people to enact disposition events of property. They won’t feel locked into their investment; thus, capital will flow more freely in the market.

(3) Inflation – There is an argument that purchase and appreciation of capital assets have some component of inflation in them. Thus, there is a sense that basis should be adjusted to account for this. This would be highly difficult to administrate. Capital gains preference is another option.

(4) Economic Incentives for Investment – Long-term saving should be encouraged and this is one way of incentivizing it.

(5) Double Tax on Corporate Earnings – We already have a double tax for corporations. Alleviating some of it through long term capital gains preference is beneficial.

**Section 1211 (Capital Loss Carrybacks and Carryovers)**

**- 1211(a) (Corporations)**: A corporation’s capital losses are limited to its capital gains (basketing)

- §1212(a): corps’ unused capital losses can be carried back up to 3 yrs and can be carried forward up to 5 yrs as Short-Term cap losses.

- §1212(b): individual cap losses retain their character (ST or LT) and are carried forward forever.

- **1211(b) (Other Taxpayers)**: Individual taxpayers’ capital losses are also limited to capital gains but the excess can be deducted from ordinary income up to $3,000

- **Policy Rationale:**

**-** Prevents “cherry-picking” of losses

- Protects tax revenues

**Tax Avoidance/Tax Shelters**

**Elements of a Tax Shelter**

(1)Deferral – pushing income into the future by incurring costs that are currently deductible 🡪 time-value of money.

(2) Conversion – Converting ordinary income into tax-favored income, such as capital gains (lower ratios)

(3) Tax Arbitrage – Incurring expenses that are deductible in order to generate income that is tax-favored, thereby creating a tax loss in excess of any economic loss (e.g. borrowing to buy tax-exempt bonds, unable to do so today because of **Section 165**)

**What are Tax Shelters?**

- attempt to take advantage of tax benefits without the commensurate economics

- Tax loss sheltering other income

Debt Included in Basis

*Crane v. Commissioner* (1947)

TP argues that “property” = “equity”

IRS: “property” = value of asset including debt

IRS wins

IRS allows early depreciation deductions = $30K

“recaptures” same amount at sale

Although IRS won the case, this is also a gain for tax payers in general b/c it allow deferral (i.e., time/value of money)

- Did *Crane* fuel future “Tax Shelters”?

advantages of non-recourse debt in questionable tax transactions:

1. Limited Economic Risk

2. Allowed for inflated depreciable basis

but if it’s non-recourse debt, then there is no economic risk

*Crane’s* Progeny & Legitimate Debt

*Estate of Franklin* (1976)

Sale/leaseback deal: TP buys Hotel with non-recourse debt > FMV of Hotel

Court: debt lacked economic substance (unlikely to be repaid)

debt **not** included in basis

What factors point to sham transaction?

- too much spread btw the price of the asset and the FMV

- no exchange of income

- transaction is financed from non-recourse debt (i.e., no risk)

- buyer receives financing from seller

*Pleasant Summit Land Corp* (1988)

- non-recourse debt > FMV shall be included in basis, BUT only to the extent of FMV

Also be familiar with *Tufts*

The Opinion Letter

What is it?

letter written by lawyer

Why do they vary?

b/c diff attorneys have different levels of creativity in dealing with the tax laws

- since they vary, it leads clients to “shop around” until they get the opinion letter that they want

Why have it?

the search for “more-likely-than-not” legal opinions

-Lawyers face ethical issues b/c want to get clients, and clients want them to write something specific.

Ethical Issues – The Law.

ABA’s Formal Opinion 85-352: when a tax lawyer takes a position, he/she must have a “good faith belief” in the position

* + - * “realistic possibility” of successful litigation
  + §6662 “accuracy-related” penalty
    - “substantial understatement” & “substantial authority”
  + Treasury’s Circular 230
    - attorney can’t take position, unless there is a “realistic possibility” or “non-frivolous” & “disclosure”
      * reason for long disclaimer on bottom of e-mail correspondences
  + §6694(a) penalty
    - there are penalties for tax preparers as well
      * if there isn’t a “realistic possibility”; knowledge requirement; disclosure

**Policy Concerns**

- Distortion of tax incentives (Accelerated depreciation is meant to incentivize investment in capital-intensive industries. Doctors and lawyers have no interest in substantially fostering those industries. They just want the tax benefits.).

- Funneling Economic Resources – This follows from the first point by creating large pools of economic resources in disfavored behavior. This was not Congress’ intention.

- Disconnect between risk and reward – People are going to undertake very risky behavior in order to incur great tax benefits. This is against the fundamentals of a free market.

- Greater untaxed personal consumption

- Undermines overall taxpayer morale: 2 similar situated TPs pay different taxes b/c one is using a tax shelter (messes up horizontal equity)

**Anatomy of a Real Estate Tax Shelter**

Doctor taxpayer wants to find a way to limit tax liability. Taxpayer invests $1 M in an office building by obtaining $900k non-recourse loan w/ annual interest of $90k. Taxpayer pays $100k for office. Taxpayer rents office building to tenants, who pay rent annually of $90k to taxpayer.

On pre-tax basis, taxpayer pays $90k interest and receives $90k in rent every year

Tax Benefits: Taxpayer takes annual depreciation deductions of $50k

Taxpayer’s basis in the building will drop. However, the time value of money and lower tax rate for long term capital gains will be his benefit.

**Knetsch v. US (1960)**

Taxpayer borrows nonrecourse to buy deferred annuity

Issue: Is interest expense deductible

Holding: No deduction because transaction was a sham. It had no non-tax economic rationale

**Implication of Knetsch**

**Economic Substance Doctrine**

A loan interest deduction is proper if there is some substance to the loan arrangement beyond the taxpayer’s desire to secure the deduction (if there is a mixed motive). On the other hand, an interest deduction should not be permitted when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer’s desire to obtain the tax benefit of an interest deduction.

**Estate of Franklin v. Commissioner (1976)**

Buyer (partnership) buys hotel from Romneys (original owners) using a loan transaction. Buyer pays 75k in prepaid interest. Romneys make rental payments to buyers in exchange for identical loan payments in a lease-back.

Partnership receives tax deferral from upfront depreciation deductions given back later

Romneys are receiving 75k of income and avoid the realization event on sale of Motel through installment sale

Tax court focuses on the fact that there is no sale, no legitimate loan, no real ownership

9th Circuit: Deductions are not allowed because this is a sham transaction. It is not a bon fide sale. The buyer/taxpayer is not the true owner because there is a lack of equity in the investment.

**Congressional Response**

**Section 469 (Passive Activity Loss Rule)**

Limits deductions from passive activity losses

**Treas. Reg. 1.469-5T** defines the tests to be used to define what passive activity/material participation is

Provides an example of netting/basketing – passive activity losses can only be used against passive activity income.

**Section 465 (At Risk Rules)**

Disallows deductions for “losses” of an investment that are greater than the amount put at risk